The role of tax incentives in a trio of Sub-Saharan African economies : a comparative study of Nigerian, South African and Kenyan tax law.

Oyetunde, Samson Oyebode

THE ROLE OF TAX INCENTIVES IN A TRIO OF SUB-SAHARAN AFRICAN ECONOMIES: A COMPARATIVE STUDY OF NIGERIAN, SOUTH AFRICAN AND KENYAN TAX LAW

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Queen Mary
University of London

SAMSON OYEBODE OYETUNDE
CENTRE FOR COMMERCIAL LAW STUDIES
QUEEN MARY, UNIVERSITY OF LONDON, ENGLAND

I hereby declare that the work presented in this Thesis is my own.

Signature:

Date: 16/09/08

ABSTRACT

This Thesis evaluates the role of tax incentives in promoting sustainable economic development in developing countries, comparing the South African and Kenyan experiences with that of Nigeria, with a view to suggesting ways in which Nigerian tax incentive law and policy may be improved.

After a general introduction in Chapter 1, Chapter 2 considers the nature of tax incentives as policy tools for economic development, reviews typical forms of incentives and highlights traditional arguments for and against their use as found in the literature. While there is a general consensus among economists that tax incentives are generally ineffective and inefficient policy tools the use of which should be generally discouraged, this view has not been universally accepted among developing country policymakers.

Chapters 3, 4 and 5 present findings from bibliographical and qualitative research into the role of tax incentive laws, practices and policies in Nigeria, South Africa and Kenya (respectively). Chapter 6 considers important regional and international tax, trade and finance issues which constrain or otherwise influence the use of tax incentives by developing countries with particular reference to the circumstances of these three countries.

Chapter 7 traces the evolution and critiques the content of contemporary Nigerian tax incentive policy. It finds that Nigerian tax incentive law and policy while clear is not entirely consistent, prudent or appropriate in view of contemporary development needs, available resources and national priorities. However, it also finds that Nigerian tax incentive policy may be significantly improved if certain lessons from the South African and Kenyan experiences are carefully considered and applied with an appreciation of the peculiar realities of Nigerian tax culture.

In particular, Nigeria should: target tax incentives to only those sectors where the benefits justify the attendant revenue loss; ensure that tax incentives are not only fit for purpose but are also cost-effective; dispassionately review the true economic rationales for tax incentives; count the cost of tax incentives to assess their cost-effectiveness; and adequately consult with the private sector. Further, Nigeria should: keep tax incentive policies and practices simple; use non-tax measures wherever possible to encourage growth in key sectors; and strive for a dynamic, sustainable and responsive tax incentive policy. Finally, as tax policy is only as effective as tax administration allows, sufficient and sustained attention must be placed on improving the capacity, quality and effectiveness of Nigerian tax administration.

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DEDICATION

I dedicate this Thesis

To Dad – who placed me on the path of law;

To Mom – who placed me on the path of accounting;

To Oduntan – my dearest friend and companion along the way;

& to the Good Lord – who kept my feet from straying.

1. PROEM

"In the beginning there was a river.
The river became a road and the road branched out to the whole world.
And because the road was once a river it was always hungry. In that land of beginnings spirits mingled with the unborn … As we approached another incarnation we made pacts that we would return to the spirit world at the first opportunity … Those of us who made such pacts were known among the Living as ***abiku****, spirit children …*
We were the ones who kept coming and going, unwilling to come to terms with life."[1]

1.1. INTRODUCTION: THE *ABIKU'S* PATH TO LIFE

This Thesis considers the role of tax incentives in promoting sustainable economic development. This theme may be depicted by the plight of the *Abiku* child in her journey up the winding road towards the river of life. In *Yoruba*[2] traditional lore, an *Abiku* is a spirit-child who lingers on only a little while after birth, often dying before puberty. Such spirit-children keep coming and going, being reincarnated as subsequent children; until the appropriate rites are performed, their chances of survival remain uncertain.

So it seems to be the case with Nigeria: a still-born nation that lingers between its unfortunate past and the possibility of a future of new hope, ushering in a time of increased prosperity of her people. As the tales of the *Abiku* are intertwined with life and death, joy and despair, so also has the history of Nigeria been chequered with prosperity and austerity, growth and decline, unity and division. Unfortunately, the saga of Nigerian economic development is fact and not fiction, a grim reality of false starts and unfulfilled potential. But like the *Abiku,* Nigeria can choose to take the opportunities presently

1 Ben Okri *The Famished Road* (Vintage, London: 2003), pp.3-4. (Emphasis mine.)

available to her, perform the necessary 'rites', and remain and indeed, thrive in the land of the living this time around. This Thesis critically considers the possibilities surrounding of one of such 'rites' – the use of tax incentives law and policy – in promoting sustainable economic development in Nigeria, drawing parallels and exemplars from two other Sub-Saharan African nations: South Africa and Kenya.

1.2. TAX INCENTIVES AS SELECTIVE INTERVENTIONS

Commercial transactions are conducted within a matrix of legal and regulatory infrastructure which influences the nature of the investment environment. Such economic regulation is composed of multiple facets including corporate and commercial law, trade law, competition law, and banking and finance law. Taxation is also often seen as a policy tool which may be used to influence the business environment and promote economic development, not by its uniform levy by but its selective absence, to encourage certain types of economic activity over others.

Although policies targeted at improving the investment climate may ultimately impact all firms and activities, specially targeted incentive policies may benefit some sooner than others. Consequently, governments often seek to accelerate economic growth through the implementation of selective support for particular firms and special activities.[3] Early beneficiaries of such selective interventions include the English wool industry in the 14th/15th centuries, post-World War II Latin America[4] and export enterprises of East Asian countries in the late 1960s/early 1970s. Such selective interventions included competition and market restrictions, information-based policies, credit initiatives, public-private sector interventions and tax incentives.[5] This Thesis

2 The *Yoruba* are one of the main ethnic nationalities in Nigeria, to which this Researcher belongs.

3 . World Bank *World Development Report 2005: A Better Investment Climate For Everyone*, (World Bank/Oxford University Press, New York: 2004) Chapter 8.

4 E.g. the import protection of infant industries in Argentina, Brazil and Chile.

5 World Bank, *World Development Report 2005*, *op cit*, p.159.

seeks to critically explore one of such paths – tax incentives law and policy – with a view to determining what role this policy tool may play in assisting the Nigerian *Abiku* to gain purchase on the road to sustainable economic development.

1.3. A Focus on the Role of Tax Incentives

Taxation plays a crucial role in economic policy by generating revenue for governments to finance public services, facilitate growth, increase productivity, improve their investment climates and enhance the overall quality of life of their peoples. However, taxes raise the cost of doing business and weaken the link between investment and resultant returns, thereby impeding economic growth and development.[6]

Tax incentive laws have consequently been used by governments as a policy tool for accelerating investment in specific economic sectors, shaping the investment environment of a country or economic region and so overcoming some of the challenges posed by adverse investment conditions.[7] On 13 February 2008, US President George W. Bush signed into law the *Economic Stimulus Act of 2008* (H.R. 5140)[8] to complement monetary policy interventions in the American economy. The Act provides timely, targeted and temporary tax incentives of over US$152billion (1% of US GDP) by way of tax rebates[9] and accelerated capital expenditure[10] write-offs to mitigate recessionary pressures

6 *Ibid,* Chapter 5.

7 Jacques Morisset and Neda Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review' in Wells *et al, Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?* Foreign Investment Advisory Service, Occasional Paper 15 (IFC/World Bank, Washington D.C.: 2001) pp.69-108.

8 See <http://taxprof.typepad.com/taxprof_blog/files/h.R.%205140.pdf>.

9 Tax incentives include rebates of US$600 per person, US$1200 per married couple and an additional US$300 per child.

10 Allowable capital expenditure deductions are to be doubled to US$250,000 for businesses.

on the US economy exerted by the 2007/2008 credit crunch crises and stimulate consumption, investment and job creation.[11]

Tax incentives typically utilised in Sub-Saharan African economies include tax holidays, investment allowances, tax credits, reduced corporate taxes, VAT and duty exemptions, subsidies, special regulatory exemption and investment zones, and accelerated investment write-offs.[12] Candidates for such selectively preferred treatment range from export-oriented industries, industrially-intensive enterprises, rural development schemes and advanced technological projects to environmentally friendly extractive undertakings.

Yet as with all tools, where ineptly handled, tax incentives may hinder the very ends their wielders seek to advance. Interactions between source country tax concessions and tax laws in capital-exporting residence countries may distort or negate the incentive value of such initiatives if these issues are not carefully considered.[13] Tax incentives may potentially whittle down a developing country's tax base, distort investment decisions by local and foreign investors, reduce transparency in tax administration, hamper innovation and efficiency, and divert attention from effecting more fundamental economic and political reforms necessary to guarantee a sustainable and favourable investment environment.[14] Indeed, the link between tax incentives and increased foreign direct investment has been criticised as tenuous and studies indicate that excessive costs may attend such incentives due to high redundancy rates.[15]

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11 Jeremy Grant, 'House passes Bush stimulus package', FT.com (Washington D.C., USA 30.01.08) <http://www.ft.com/cms/s/0/70e52dc6-cec7-11dc-877a-000077b07658.html> accessed on 01.02.08.

12 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, ASIT Advisory Studies No.16 (UN, New York/Geneva: 2000) [E.01.II.D.S.].

13 Timo Viherkenttä *Tax Incentives in Developing Countries & International Taxation* (Kluwer Law and Taxation Publishers, Deventer: 1991).

14 Louis T. Wells Jr. and Nancy J. Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments' in Wells *et al*, *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?*, *op cit*, pp.1-67.

15 *Ibid*, pp.21-26,45.

1.4. RESEARCH OBJECTIVES

Although there is much debate over their economic rationales and actual effectiveness, tax incentives still play a significant role in improving economic conditions in the region given the numerous fiscal incentives in current Nigerian, South African and Kenyan statutes and policies. There is a dearth in recent comparative academic literature on the role of tax incentive laws spanning these economic regions within Sub-Saharan Africa. For instance, much of the literature on Nigerian tax incentives stems from the discipline of economics[16] and is dated.[17]

Consequently, this Study seeks to fill this lacuna through the critical examination of the actual and perceived role tax incentives play in three Sub-Saharan African countries. While the use of statistics and econometrics in traditional economics has advanced understanding of the challenge of economic development, policy prescriptions should not be sterilised from the dynamic cultural, political, administrative and legal environments within which they are intended to operate.[18] By considering tax incentives primarily from a legal perspective, this Thesis recognises these fundamental, environmental frameworks which not only shape the manner in which tax incentives are fashioned, but also affect their implementation, administration and review.

By analysing the various incentive laws of these countries, reviewing the practical realities of their administration, evaluating conflicting perspectives on their efficacy, and considering local and international evidence on their roles in advancing regional economic development, this Thesis makes a distinct and original contribution to knowledge in this field. This Thesis provides an original exposition of the Nigerian legal regime for tax incentives; compares

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16 See Shamsuddeen Usman 'Tax Incentives & Investment in the Nigerian Oil Industry (1966-1977)' (PhD Thesis, London School of Economics & Political Science, 1980). Dr. Shamsuddeen Usman is currently Nigeria's Finance Minister.

17 See Idowu Salaudeen Lajire Agboola 'Company Taxation in Nigeria: with Special Reference to the Anti-avoidance Provisions and to the Tax Incentives' (PhD Thesis, University of London, 1968).

18 Michael Todaro, *Economic Development*, (7th edition, Pearson Education Limited; Addison-Wesley, Essex: 2000) pp.11-13.

this exposition with a review of tax incentive practices in South Africa and Kenya; considers the influence of key international tax, regional integration, trade and finance issues; and concludes with a critical analysis of contemporary Nigerian tax incentives policy using exemplars derived from the experiences of South Africa and Kenya.

More specifically, this Thesis addresses the following research questions:

- What is the general role of tax incentives in promoting sustainable economic development in Nigeria, South Africa and Kenya?

- What kind of tax incentives are currently used in Nigeria, South Africa and Kenya?

- What are the contemporary trends in tax incentives law and policy in these three study countries?

- What constraints do international tax law, regional integration arrangements and international trade/financial architecture impose on the use of tax incentives in South Africa, Kenya and more specifically, Nigeria?

- Is contemporary Nigerian tax incentives policy clear, consistent, prudent and appropriate in view of contemporary development needs, available resources and national priorities?

- What lessons can Nigeria derive from the South African and Kenyan experiences to improve tax incentive law and policy? and

- What matters limit the scope of this Study and therefore impose constraints on the applicability of its findings?

Where the potential role of tax incentives is considered to be significant and positive, this Thesis suggests how best underlying economic and policy objectives may be achieved through the use of tax incentives. Where, however, this role is perceived to be marginal or indeed, counterproductive, this Thesis considers why the use of tax incentives persists despite being proven to be suboptimal or otherwise adverse to economic development.

1.5. THE STUDY'S REGIONS, COUNTRIES & RESEARCH METHODOLOGY

1.5.1. A Focus on East, West & Southern Africa

This Study focuses on three regions in Sub-Saharan Africa: West Africa, Southern Africa and East Africa. A number of reasons inform the exclusion of Central and North Africa from this Study. The **Central African region** has recently been hobbled by political instability, armed conflicts and *coups d'état,* particularly in the Great Lakes region.[19] Tax incentives often play an important though secondary role in inducing desirable types of investment behavior. This role may be significantly hampered where crucial economic and political fundamentals are lacking or inadequate. Unlike most Central African countries, all three study countries are coastal nations with major shipping ports and a long history of international trade. Tax incentives tend to be optimally utilised in export-oriented industries. Finally, given the complicated political, lingual, historical and cultural development of Central Africa, the scope of this Study would be unduly broadened by including this region.

North Africa has been excluded for analogous reasons. North Africa is relatively the most prosperous region, leading continental growth in recent times. Most of the countries of this region are well on their way to meeting their Millennium Development Goals by 2015. However, recent events in the North African and Middle East region[20] have negatively affected the region's

19 Particularly recent armed conflict in Burundi, Democratic Republic of Congo and Rwanda; and attempted or successful *coups d'état* in the Central African Republic, Equatorial Guinea and Sao Tome & Principe.

20 Particularly the crisis in Darfur (Sudan) and the war in Iraq.

economic prospects. The geographic proximity to the Middle East and the shared religious and cultural connections further differentiate this region from Sub-Saharan Africa. As such, it is considered best to confine this Study to the selected economic bourses (*viz.*, ECOWAS/WAEMU,[21] SADC/SACU[22] and COMESA/EAC Customs Union[23]) and the role of tax incentives in the North and Central African regions would not be examined.

1.5.2. **A Focus on Nigeria, South Africa & Kenya**

This Thesis focuses on the role of tax incentives in a trio of Sub-Saharan countries: Nigeria, South Africa and Kenya. These study countries are all among Africa's Ten Largest Economies, a class which collectively constitutes 55% of Africa's population and 75% of its GDP.[24] The study countries have the largest economies in their respective regions and trade surpluses with their regional neighbours. Consequently, they have the economic size and potential to alter the fortunes of their respective regions and improve the economic fortunes of Sub-Saharan Africa. Each of the study countries has different socio-political challenges to overcome in their journeys towards similar economic goals. The recent historical development, political constitution and economic performance of these countries are noted in Chapters 3, 4 and 5.

1.5.3. **Research Methodology**[25]

This Study uses doctrinal and reform-oriented legal research methodologies to trace the evolution and incorporation of tax policy into legislation and

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21 The Economic Community of West African States and the West African Economic Monetary Union (respectively) which both include Nigeria.

22 The Southern African Development Community and the Southern Africa Customs Union (respectively) which both include South Africa.

23 The Common Market for Eastern and Southern Africa and the East African Community Customs Union (respectively) which both include Kenya.

24 In 2003, Nigeria, South Africa and Kenya ranked as fourth, first and tenth respectively in terms of GDP: AfDB, *African Development Report 2004: Africa in the Global Trading System* (Oxford University Press, New York: 2004), p.5; *African Development Report 2007: Natural Resources for Sustainable Development in Africa* (Oxford University Press, New York: 2007) p.xx.

25 See generally Terry Hutchinson, *Researching and Writing in Law* (2nd ed, Lawbook Co., Sydney: 2006); Steinar Kvale, *InterViews: an introduction to qualitative research interviewing* (Sage Publications, Thousand Oaks: 1996); and Jennifer Mason, *Qualitative Researching* (Sage Publications, London: 2002).

common law in the study countries. While much of this Study was conducted by doctrinal research in libraries in Abuja, Amsterdam, Ibadan, Johannesburg, Lagos and London, this research was complemented by qualitative personal interviews, teleconferences and focus group discussions with senior government officials, policymakers, civil servants, tax accountants, lawyers and other experts, conducted mainly during Field Trips to Nigeria and South Africa. These qualitative techniques were appropriate given the policy-oriented nature of this Study. A comparative methodology was utilised to derive valid exemplars from the historical and descriptive review of the South African and Kenyan experiences that may prove useful in criticising and reforming Nigerian tax incentive law and policy.

This Researcher obtained a great deal of information and data during Field Trips to Nigeria and South Africa. While some difficulty was encountered in obtaining data, information and perspectives on tax incentives in Kenya, these challenges were largely overcome by the invaluable assistance of professional tax and accounting firms in Kenyan and other key individuals whose efforts helped this Researcher to procure relevant data, statistics and perceptions. Consequently, the challenges encountered in researching Kenyan tax law and policy do not materially impair comparisons made with (or possible lessons for) Nigeria.

1.6. THE THESIS IN OUTLINE

This Chapter introduces this Study by highlighting its scope, subject matter, objectives and research methodology. Chapter 2 will critically consider the nature and use of various types of tax incentives as policy tools for economic development highlighting key issues, noting relevant debates to further demonstrate the importance of extended scholarly examination of this topic. Chapter 2 reviews typical forms of tax incentives and highlights traditional arguments for and against their use. This literature review sets the scene for subsequent policy articulation and analysis.

Chapters 3, 4 and 5 are the outcome of bibliographical and qualitative research into the role of tax incentive laws, practices and policies in each study country. However, while Chapters 4 and 5 merely review South African and Kenyan tax incentive regulations, an original exposition is made of Nigerian tax incentive laws and policies in Chapter 3. This exposition was necessary as this Researcher did not find any singular text or resource that comprehensively reviewed the whole gamut of Nigerian tax incentives law and practice. Chapter 3 forms the backdrop against which South African and Kenyan tax incentives may be compared. Chapters 3, 4 and 5 collectively form a prequel to the review in Chapter 6 of regional and international tax, trade and finance issues which influence the use of tax incentives in developing countries.

Chapters 3, 4 and 5 also provide the foundation for the critical analysis in Chapter 7 of contemporary Nigerian tax incentive policy using exemplars derived from the South African and Kenyan experiences. The concluding Chapter 8 summarises the findings of this Study. Essentially, this Thesis traces and illuminates the journey of the Nigerian, South African and Kenyan *Abiku* along the rivulets of tax incentive laws, towards the river of sustained economic development. But first it is proper to critically review the literature on the role of tax incentives as a policy instrument for advancing of sustainable economic development.

This Thesis is based on information available up to 1 February 2008 in respect of South Africa and Kenya, and 1 March 2008 in respect of Nigeria.

2. TAX INCENTIVES AS A POLICY TOOL FOR SUSTAINABLE ECONOMIC DEVELOPMENT

"For the rational study of the law the black letter man may be the man of the present but the man of the future is the man of statistics and the master of economics ... We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the other advantage we lose, and to know what we are doing when we elect."[26]

2.1. OVERVIEW

This Chapter explores the nature of tax incentives by examining various aspects of these policy instruments. It evaluates the diverse ends tax incentives may serve in promoting sustainable economic development in developing countries. It delves into the debate over the efficacy of tax incentives by highlighting perceived difficulties that attend their use. In conclusion, it finds that though their use is fraught with challenges, tax incentives may, when prudently designed, implemented and reviewed promote sustainable economic development in certain circumstances. How this venture has been undertaken in Nigeria, South Africa and Kenya forms the subject matter of Chapters 3, 4 and 5.

26 Oliver Wendell Holmes Jr., 'The Path of the Law' 10 Harvard Law Review (1897) pp.475,469,474.

2.2. Basic Definitions

2.2.1. Tax Incentives

The phrase 'tax incentive', though subject to much academic analysis, has not been exhaustively defined.[27] Shah provides a good working definition of tax incentives as:

> ... those provisions in the tax code that afford **preferential treatment** to some **activities** over others (say, tax holidays and credits for investment in manufacturing industries), some **assets** over others (accelerated depreciation provisions for specified assets), some **form of organization** over others (for example, lower tax rates for small rather than large businesses), or some **forms of financing** over others (debt over equity).[28]

This paradigm focuses on fiscal measures that are specifically designed to encourage capital accumulation in specific economic sectors, change the time distribution of the use of assets and positively influence the investment and financing aspects of business decisions.[29]

Viherkenttä rightly emphasises the **intentional** nature of tax incentive policies, arguing that tax concessions which ultimately promote foreign investment, though not originally intended to have such an effect, should fall beyond the scope of tax incentives *per se*.[30] Viherkenttä also argues for limiting the phrase 'tax incentives' to encompass fiscal measures influencing active business operations of domestic and foreign investors as opposed to policies for passive investment more commonly associated with tax havens.[31] However, an exceptionally low corporate tax rate which promotes economic activity (say, in financial services) could conceivably qualify as a tax incentive given the

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27 Most definitions in the literature correspond more closely with *(foreign) investment incentives*: IBFD International Tax Glossary, Barry Larking (ed) (5th edition, IBFD, Amsterdam: 2005), pp.179,237.

28 Anwar Shah 'Overview' in *Fiscal Incentives for Investment and Innovation*, Anwar Shah (ed) (Oxford University Press, New York: 1995), p.2 (emphasis mine).

29 *Ibid*.

30 Viherkenttä, *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.6,17-19.

31 *Ibid*, p.6.

intended and actual effect such policies have had on investment.[32] To the extent that such incentives are intended to and actually influence financing and investment decisions of economic agents, these measures shall be considered here as tax incentives.

Tax incentives for the present purposes broadly correspond to Shah's definition[33] insofar as these affect actual financing and investment decisions. As much of the literature on tax incentives considers their role in encouraging Foreign Direct Investment (hereafter: FDI), many common definitions correspond to that of *FDI incentives*.[34] These have been described elsewhere as any measurable advantages accorded to specific enterprises by governments to encourage them to behave in a certain way which include measures specifically designed to either increase the rate of return to FDI or to reduce associated costs and risks.[35]

As this Thesis primarily considers tax incentives for sustainable economic development, the bias in some of the literature towards *FDI incentives* shall not be replicated here. Although the vast majority of foreign investment in the trio of study nations is constituted by inflows from Western industrialised nations, investments from and trade with other developing nations are becoming more important.[36] The role of domestic and regional private capital formation should also not be overlooked.[37] Consequently, the approach adopted here will be consistent with this Thesis' objectives to consider Sub-Saharan African regional development, and how, if at all, fiscal measures can assist in promoting economic development in a sustainable way.

32 E.g. in Hong Kong and Ireland: UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.15.

33 Shah, 'Overview' in *Fiscal Incentives for Investment and Innovation*, *op cit*, p.2.

34 Wells *et al*, *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?*, *op cit*; Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*; UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*.

35 UNCTAD/DTCI, *Incentives & Foreign Direct Investment*, Current Studies, Series A, No.30 (UN, Geneva: 1996) [E.96.II.A.6], p.3.

36 OECD/AfDB, *African Economic Outlook 2003/04 – Country Studies: South Africa*, pp.285,287.

2.2.2. Sustainable Economic Development[38]

In this Thesis, the concept of sustainable[39] economic development adopted would be that espoused by contemporary development economists such as Todaro and Smith,[40] who conceive of development as a

> multidimensional process involving major changes in social structures, popular attitudes, and national institutions, as well as the acceleration of economic growth, the reduction of inequality and the eradication of poverty ... represent(ing) the whole gamut of change by which an entire social system, tuned to the diverse basic needs and desires of individuals and social groups within that system, moves away from a condition of life widely perceived as unsatisfactory towards a situation or condition regarded as materially and spiritually better.[41]

The work of Amartya Sen on freedom as a *capabilities approach to function* provides deep insights into the nature of underdevelopment and poverty. Crucially, development is seen as a process of enhancing the quality of human existence and the spectrum of individual liberties: to be,[42] to achieve[43] and to be free.[44] While increasing growth in incomes measured by economic statistics may indicate improvements in economic development, narrowly defined, this may not necessarily correlate with higher levels of broader human 'development'.

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37 UNCTAD, *World Investment Report 2004: The Shift Towards Services* (UN, New York: 2004), p.3.

38 See Michael Todaro and Stephen C. Smith *Economic Development* (9th edition, Pearson Education Limited, Harlow/Essex: 2006), chapter 1.

39 See Sharachandra A. Lee (1991) 'Sustainable Development: A Critical Review', World Development, Vol. 24, pp.215-255.

40 Todaro and Smith *Economic Development* (9th ed), *op cit*, chapter 1.

41 *Ibid*, p.17.

42 Corresponding to the innate human desire for self-esteem, respect, dignity and to be recognised by and contribute to one's society: *ibid*, pp.21-22.

43 Essentially the instinctive yearning to meet life-sustaining basic needs consistent with human existence: *ibid*.

44 This connotes the inborn desire to be free from external physical and social constraints on the ability to choose: *ibid*.

As Sen observes:

> Focusing on human freedoms contrasts with narrower views of development, such as identifying development with the growth of gross national product, or with the rise in personal incomes, or with industrialization, or with technological advance, or with social modernization. Growth of GNP or of individual incomes can, of course, be very important as *means* to expanding the freedoms enjoyed by members of the society. But freedoms depend also on other determinants, such as social and economic arrangements ... as well as political and civil rights...[45]

Therefore 'economic development is a necessary condition for the improvement in the quality of life that is development'.[46] Sen attributes the divergence between the economic progress and broader human development to factors such as personal heterogeneities flowing from individual traits and circumstances, environmental and geographical diversities, social climate variations, differences in perspectives across communities, and the distribution of wealth and opportunities in families, clans and social units.[47]

In this Thesis, a multidisciplinary approach would be adopted where necessary, drawing insights from law, economics, accounting, corporate finance and other disciplines. This emphasis on sustainable development assumes added urgency in the quest to increase economic growth and reduce poverty across a wide section of contemporary developing economies – economies which do not always conform to theoretical hypotheses espoused by traditional neoclassical economics, but which are significantly influenced by the broader political, historical, legal, social, cultural and religious contexts within which they evolve and exist.

The next section (§**2.3**) considers types of contemporary tax incentives.

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45 Amartya Sen *Development as Freedom* (Oxford University Press, Oxford: 1999), p.3.
46 Todaro and Smith *Economic Development* (9th ed), *op cit*, p.21.
47 Sen *Development as Freedom*, *op cit*, chapter 1.

2.3. TYPES OF TAX INCENTIVES

2.3.1. Overview

While there is a great deal of variety in investment incentives, subsidies and outright grants are more common in developed nations unlike the tax holidays, preferential treatment of investment costs and tax rate reductions favoured by many developing countries.[48] However, some of the tax incentives typically used in developing countries have been criticised as being of the least effective types.[49] Tax incentives range from tax exemptions, tax deferral, tax deductions, special or preferential tax rates to tax credits. These measures operate at successive stages in the process of determining the liability of taxpayers.[50] Tax incentives may be broadly classified into the categories enumerated below.

2.3.2. Preferential Tax Rates & Tax Holidays

Tax-paying firms may be granted the reduction or removal of tax liabilities on a temporary or permanent basis. **Reduced tax rates** may be restricted to certain geographic regions and apply to key economic sectors or categories of taxes.[51] Reduced corporate income tax rates have been successfully used in countries with relatively small economies such as Hong Kong, Lebanon, Ireland, Cambodia and Estonia.[52] The resulting tax systems reduce tax avoidance or evasion, and indicate a preference for a more market-led economy. However, if the general tax rate suddenly drops significantly below those of neighbouring countries, the short-term revenue implications may be

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48 Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment A Review' in Wells *et al, Using Tax Incentives to Compete for Foreign Investment Are They Worth the Costs? op cit*, p.84; UNCTAD *Tax Incentives & Foreign Direct Investment: A Global Survey, op cit*, pp.16,29.

49 Vito Tanzi and Howell H. Zee (June 2000) 'Tax Policy for Emerging Markets: Developing Countries' *National Tax Journal* Vol. 53 No.2, p.315.

50 S.S. Surrey *The Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, Cambridge/Massachusetts: 1973), pp.92-126; Raymond Luja *Assessment & Recovery of Tax Incentives in the EC & the WTO: a View on State Aids, Trade Subsidies & Direct Taxation* (Intersentia, Antwerp: 2003), p.10.

51 Viherkenttä, *Tax Incentives in Developing Countries & International Taxation, op cit*, p.26.

52 UNCTAD *Tax Incentives & Foreign Direct Investment: A Global Survey, op cit*, p.15.

severe and more international tax distortions may occur than under a more tax-neutral system.[53]

A common variant of preferential tax rates is the **tax holiday** whereby a firm is granted tax-free status for a specified period of time. This incentive usually comes 'with strings attached': contingent on the achievement of certain requirements ranging from quantum of capital invested, novelty of enterprise, amount of local employment created, to location in designated priority sectors, activities or regions. Milestones signalling the commencement of the tax holiday include the year of grant of investment licences, year of first production, year of first profit or year of net cumulative profit. The duration of tax holidays varies from 2 to 25 years and may be extended on a discretionary basis. Tax holidays are attractive to investment authorities in developing and transition economies with rudimentary corporate tax systems given their ease of administration.[54]

Despite their popularity, tax holidays have been criticised by numerous commentators. If time-bound and not linked to specific profit caps, they operate as blunt policy instruments favouring high-profit projects with short-term investment horizons as opposed to longer-term and arguably more socially beneficial undertakings. To the extent that projects are undertaken irrespective of tax holidays, these measures are wasteful. Tax holidays also distort the timing of capital investment by discriminating against sequential or incremental post-holiday investment outlays.[55]

The arbitrary designation of qualifying categories and the possibility of negotiating extensions may expose tax holidays to exploitation by aggressive

53 Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review' in Wells *et al*, *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs? op cit*, p.85.

54 Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, p.26; UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.23

55 *Ibid*, p.24.

transfer pricing, foot-loose 'phoenix' enterprises[56] and tax avoidance. Unless coupled with generous tax-loss carry-forward periods, tax holidays could constitute a tax disincentive, particularly for small or risky firms by depriving these firms of tax advantages from depreciation deductions, capital allowances and tax-deductible interest.[57]

Tax holidays cause adverse consequences for the corporate tax base where transfer pricing or reverse loans[58] are used to shift income among related companies.[59] Tax holidays constrain the narrow tax bases most developing countries tend to have which rely predominantly on corporate taxation. Finally, unless tax holiday firms are required to keep records of capital expenditures and aggregate taxes exempted, post-holiday tax compliance and assessment of revenue costs could be impaired.[60]

2.3.3. Investment Tax Credits & Allowances

Investment tax credits are deductions for specified depreciable capital or other expenditure permitted to be credited by a firm against its tax liabilities. Tax credits include *flat investment tax credits*[61] and *incremental investment tax credits*[62] which lower the effective cost of capital acquisition. **Investment allowances** are similar incentives though here, a deduction as a percentage or factor of investment expenditure is provided against taxable income reducing

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56 Formed by the designation of old industries as newly qualifying firms which migrate to neighbouring jurisdictions within the same region when the tax holiday in the first jurisdiction expires.

57 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries,' *op cit*, p.316.

58 Where a tax-exempt subsidiary lends to its taxpaying parent company, the latter's interest expenses would be above-the-line and the former's interest income would be tax-exempt, achieving a perfectly symmetrical tax-exempt result.

59 Away from those which are tax-paying to those which enjoy tax holidays: Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review', *op cit*, pp.85-86,102.

60 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, pp.307,316.

61 Where credit is computed as a fixed percentage of annual qualifying investment expenditures: UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.16.

ultimate tax liability. The operation of the general tax rate affects only the investment allowance: the higher the general corporate income tax rate, the greater the incentive.[63] Investment allowances reduce pre-tax income by operating 'above-the-line', while investment tax credits reduce the ultimate tax bill, operating 'below-the-line'.

As both investment tax credits and allowances are computed in relation to qualifying capital expenditures, their value is contingent on the relevant treatment of tax losses. For non-taxpaying firms to benefit from these incentives their negative tax liabilities require a treatment symmetrical to any positive tax liabilities, rendering such liabilities refundable or, at least permitted to be carried forwards or backwards, at the election of the relevant firm, with or without interest.[64]

Investment tax credits and allowances may be more effective in promoting new investment than preferential tax rates[65] and tax holidays.[66] For instance, tax credits or allowances may be granted for value addition in processing industries by rewarding firms which increase domestic productivity and net local content.[67] Tax credits could also be granted for activities like export processing and tourism which earn foreign currencies and improve the national balance of trade position. Revenue costs associated with investment tax credits and allowances are relatively easy to assess and assist tax administrations to generate useful information. Unlike subsidies, tax credits and allowances do

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62 Where credit is computed as a fixed percentage of qualifying investment expenditures but provided in excess of a moving-average or other capital base: *ibid*, p.16.

63 Variations in corporate tax rates have no effect on the value of tax credits (indeed, non-deductible pioneer period losses may *increase* tax burden especially where the first few years involve large expenditures)*: ibid*, p.23.

64 Otherwise, tax-loss firms would be adversely affected by partial loss-offsetting measures and effectively give the government an interest-free loan: Robin W. Boadway and Anwar Shah, 'Perspectives on the Role of Investment in Developing Countries,' in Anwar Shah (ed) *Fiscal Incentives for Investment and Innovation*, *op cit*, p.33.

65 Which may only increase economic rents accruing to existing capital.

66 Which reward new firms and not new investment: Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review', *op cit*, pp.86-87.

67 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.19.

not require up-front cash outlays from public funds and only benefit profitable firms.[68] However, drawbacks associated with investment tax credits and allowances include encouraging abuses and distortions such as multiple claims, funnelling allowances and credits through conduit companies and encouraging investment in short-lived capital assets.[69]

2.3.4. **Accelerated & Enhanced Depreciation**

Investment allowances are similar to accelerated and enhanced depreciation. **Accelerated depreciation** permits qualifying capital expenditure to be written off over a shorter period than would otherwise obtain under accounting rules based on normal economic depreciation. The incentive provided by rapid write-offs may be increased by **enhanced depreciation** whereby depreciable expenditure is multiplied by a factor.[70] Generous initial allowances permitting the bulk of capital costs to be written off in the year of acquisition increase the present value of these incentives. Such allowances may be coupled with or operate in lieu of regular depreciation allowances by reducing the depreciable tax base and quantum of capital consumption stock in later years. Qualifying capital expenditure may include both tangible assets (plant, equipment, buildings and production facilities) and intangibles such as research and development (hereafter: R&D) outlays and marketing expenditure.[71]

Where limited to actual capital expenditures, accelerated depreciation (unlike investment allowances) exerts less pressure on firms to invest in short-lived assets. Indeed, investors might be encouraged to accelerate the timing of planned projects. As the revenue cost in early years is partially recovered in later years, only the timing of capital consumption is altered. Consequently, there is less incentive for firms to engage in arbitrage transactions associated

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68 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.318.

69 Unless minimum holding periods are required or investment in newer technologies produces more dynamic and efficient firms: *ibid*, p.317.

70 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.18.

71 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries', *op cit*, p.36.

with investment allowances and credits. For these reasons some commentators prefer accelerated depreciation over other incentives.[72]

2.3.5. Favourable Treatment of Tax Losses & Deductions

In certain circumstances, the treatment of **tax losses** whereby negative tax liabilities are permitted to be carried forwards or backwards against taxable income in later or previous tax periods may operate as a tax incentive by improving cash-flow. For small, risky firms such incentives may be critical. When firms experience lumpy cash-flows the ability to defer or bring forward a tax charge may prove invaluable.[73] Where loss carry-forwards are not time-bound, losses may be set-off indefinitely against future profits.

Full and multiple deductions against taxable income may be permitted for qualifying expenditure. These incentives typically target economically desirable activities such as transfer of technology and export marketing. While full expensing or multiple deductions may not greatly affect the quantum of investment outlays, they may influence the timing of expenditure by influencing firms to accelerate projects.

2.3.6. Incentives for Finance & Employment

Developing countries often provide incentives to lower the general cost of capital, encourage capital market development and improve the allocation of resources to deserving investments. As regards FDI, capital-importing countries often provide reduced withholding taxes on outbound dividends and interest. This policy may be criticised for providing foreign investors with perverse incentives to strip source country assets of income instead of reinvesting revenues.[74] However, preferential treatment of capital gains by tax rate reductions may ameliorate this bias.[75]

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72 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries,' *op cit*, p.317.

73 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.33.

74 Preferring foreign investors in this way may lead to lobbying for the extension of incentives to indigenous investors who may not actually be influenced by these

Cash grants, disbursements from investment funds, subsidised loans, corporate tax imputation and flow-through of tax write-offs to shareholders illustrate the range of investment incentives available for corporate finance. Favourable tax treatment of income for municipal debt instruments and collective savings schemes may positively affect capital market growth, harness longer-term investment funds and deepen emerging bond markets. However, there may be a tension between tax incentives for capital market development and the opportunity to collect (at low administrative costs) large revenues by taxing the formal and well-organised financial sector.[76] In weighing the merits of domestic capital market development against the costs of **tax incentives for corporate finance**, adequate consultation among policymakers, investment promotion bodies, central banks and tax authorities is desirable to ensure that the right balance is struck between these important, yet often conflicting ends.

Governments may also find it expedient to utilise **employment tax credits or allowances**, wage subsidies and deductions for training costs to ease the burden of social security contributions, reduce unemployment, rectify other labour market imperfections or achieve other objectives.[77]

2.3.7. Indirect Tax Incentives & General Policy Instruments

The effectiveness of indirect tax incentives and other general policy instruments depends on the appropriateness of the particular policy tool to deliver desired economic outcomes. Governments often use **zero or reduced tariffs and taxes** on imported capital equipment and **increased tariffs** on imported goods to protect infant industries from foreign competition. However, such incentives may contravene international trade agreements, foster capital and commodity market distortions, stifle competition and

incentives: Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, pp.3-67..

75 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, pp.18-19.

76 *Developing Government Bond Markets: A Handbook* (World Bank/IMF, New York: 2001), p.38.

77 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.19.

perpetuate inefficiencies by protecting unproductive industries to the detriment of consumers.[78]

Tanzi and Lee suggest that providing rapid VAT refunds would be more effective in improving the cash-flow of firms than exempting capital inputs from VAT. On the other hand, **exempting inputs** for the production of export goods **from import tariffs** would be an effective way to eliminate this added cost component provided the inputs are properly utilised and arbitrage transactions seeking to exploit the tax wedge between allowed and disallowed inputs are effectively blocked.[79]

2.3.8. **Export Processing & Free Trade Zones**

Governments often create special investment zones with tax exemptions, investment concessions [80] and bespoke infrastructure for (export-oriented) investments which foster value-adding services, create employment and facilitate the transfer of technical skills and cutting-edge technology. Although **zone incentives** may be protected from abuse by physical controls (e.g. secure customs perimeters), administrative and institutional defects may lead to revenue leakage. [81] Zone incentives may be contrasted with more extreme incentives by way of reduced or non-existent income taxes in tax havens designed to attract global, internationally-agile multinational corporations especially in banking, internet and insurance services. However controversial they may be, **tax haven incentives** have contributed to enhanced economic growth in services for such countries despite global efforts to combat harmful tax competition.[82]

The next section considers certain justifications for tax incentives.

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78 *Ibid.*

79 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.318.

80 For foreign exchange controls and the employment of expatriate staff.

81 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.318.

2.4. THE ROLE OF TAX INCENTIVES IN DEVELOPING ECONOMIES

2.4.1. Overview

Tax incentives have promoted diverse types of entrepreneurial activities, ranging from daring feats of giant-slaying in Biblical times[83] to more modern, less risky ventures such as those promoted by Singapore's Operational and Regional Headquarters Programme.[84] The latter scheme grants tax incentives by way of 3-year reduced tax rates to multinationals and foreign affiliate companies of various sizes which establish their international or regional headquarters in Singapore. The relatively successful programme was revised in 2003 and has been reported to have created over 1,600 highly skilled jobs and US$600million in new wealth. Such initiatives have established Singapore as premier hub for corporate headquarters in Asia despite competition with similar schemes in the region.[85] Tax incentives serve various other uses between these extreme ends of the spectrum as considered below.

2.4.2. Offsetting the Corporate Tax Distortion

One of the roles served by the corporate income tax in developed countries is to effect the withholding of tax at source on corporate equity income.[86] In its absence, direct or indirect personal income taxes levied on households would not result in the comprehensive taxation of corporate capital gains on an accrual basis. By retaining and reinvesting earnings in corporate vehicles, individuals and households defer tax liabilities. This problem would be more accentuated in 'growth' companies with low dividend pay-out policies which

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82 Tax havens attracted FDI inflows of over US$200billion between 1985 and 1994 in the Caribbean and Pacific regions: Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review' *op cit*, pp.81,87-88.

83 *Viz.*, the tax holiday reportedly offered by the Israelite King Saul to any hero who would slay the Philistine giant, Goliath. However, it is unclear from the record whether the qualifying candidate, David, and his family ultimately received the promised, indefinite income tax holiday: 1 Samuel 17:17-27,48-58 in the Holy Bible (Thomas Nelson, Nashville: 1982).

84 Box V.6: 'Singapore: Going for Headquarters' in UNCTAD, *World Investment Report 2004*, *op cit*, p.198.

85 See Box V.7 'The Republic of Korea: a regional business services hub for North-East Asia?': *ibid*, p.199.

86 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, pp.299-300; Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, pp.41-43.

attract investors with a preference for capital appreciation and would be less of an issue where a significant proportion of revenues are regularly paid out as dividends. [87] However, where accumulated capital gains remain untaxed, investors effectively receive an interest-free loan from the government. While governments would be understandably dissatisfied with this result, finding a satisfactory solution such as integrating the personal and corporate income tax systems may prove elusive.[88]

In open economies, imputing corporate taxes on dividends to foreign shareholders would unwind the cost-less tax transfer from residence (home) countries to source (host) countries by the use of tax credit systems.[89] In such open economies, it has been argued that corporate tax creates distortions in capital markets in that equity finance would be optimal for households while firms would favour debt finance. This distortion would remain even if the personal and corporate tax regimes were merged.[90] Consequently, care must be taken in designing and implementing tax incentives to ensure that domestic investment and capital accumulation is not hindered by these distortions and equally, the beneficial aspects of the transfer of taxes from source to residence countries by the tax credit system are not lost. The best means of achieving this may be by implementing tax incentives specifically targeted at sources of domestic capital, perhaps in subtle ways such as focusing on economic sectors with large or dominant domestic participation (as such selective targeting minimizes tax transfers abroad without simultaneously appearing

87 R.A. Brealey and S.C. Myers *The Principles of Corporate Finance* (5th International Edition, McGraw-Hill: New York: 1996), p.434.

88 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, pp.37-41.

89 Where the residence country adopts a tax credit system and the source country sets its withholding tax or corporate tax rates at levels below the general rate of tax in home countries, a pure tax transfer occurs from the residence to source country as taxes paid by foreign companies in the source country would be credited under relevant rules against tax liabilities in the residence country: *ibid*, pp.40-41.

90 As (a) in open economies, the savings and investment segments of the domestic capital markets are effectively segmented due to the free entry and egress of finance from abroad; and (b) interest income would be taxable at the personal level but deductible for corporations. The tax system therefore favours equity income accruing to investors and simultaneously creates incentives for corporations to prefer debt over equity finance: *ibid*, p.41.

discriminatory).[91] But if the outcome introduces undesirable distortions between industries, reduced tax rates may be preferable.

2.4.3. Attracting & Retaining Foreign Investment

Developing countries' views on foreign direct and portfolio investment have evolved from the welcoming approaches of the 1950s/1960s, through the more cautious, critical postures of the late 1960s/early 1970s to open, positive attitudes characterising the 1980s/1990s.[92] These changing attitudes have been informed by shifting perceptions of the benefits and demerits of foreign investment. At one extreme, the immense economic power wielded by modern corporations is resented due to the adverse influence that may be (or perceived to be) brought to bear on the political and economic affairs of developing countries.[93] These concerns lie at the heart of the nationalisation/expropriation exercises, non-repatriation of earnings and other restrictions imposed on foreign investors in many developing nations in the 1960s and 1970s.

Contemporary developing countries seek to simultaneously realise the advantages of foreign investment and minimise any disadvantages in response to the pressures and potentials of globalisation. The ability of foreign investment to improve local economies – by integrating developing economies into international value chains; facilitating the transfer of technology, skills and best practices; creating new industries and employment; improving the productivity of human and natural resources; complementing domestic capital; and increasing tax revenues by expanding the domestic tax base – may outweigh any perceived disadvantages.[94] Consequently, developing countries use various strategies including tax incentives to attract and retain FDI. Indeed, some commentators suggest that the grant of tax incentives in a

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91 *Ibid*, p.53.
92 Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.1;13-15.
93 Todaro and Smith *Economic Development* (9th ed), *op cit*, pp.115-117.
94 UNCTAD, *Tax Incentives & Foreign Direct Investment: A Global Survey*, *op cit*, p.20; Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.52.

temporary basis could serve as signals of the 'quality' of the country as a destination for FDI.[95]

2.4.4. **Promoting Infant Industries & Domestic Investment**

Selective investment interventions may be more important for indigenous firms than foreign investors given the reality that the vast majority of private investment in developing economies is local.[96] Tax incentives may be useful in this regard, particularly for domestic infant industries. These infant industries might be engaged in risky, though potentially highly-profitable ventures, increasing the adverse effect of asymmetrical information on their financing options and cost of capital.

Under imperfect market conditions, the literature on adverse selection and moral hazards suggests that lenders and external investors would be unable (or unwilling) to expend resources to discern the quality of firms. Internal managers of high-quality firms would be privy to exclusive information about their firms' prospects but would be unable to convincingly convey this information to external investors and lenders as low-quality firms could successfully mimic such signals. As the motives of internal managers and external investors may not be perfectly aligned, this moral hazard creates a distorting conflict of interests. Consequently, the terms on which financing would be available may be too expensive for high-quality firms but too favourable for low-quality firms, leading to suboptimal levels of investment.[97] In these circumstances, tax incentives (e.g. investment tax credits) which

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95 E.W. Bond and L. Samuelson (1986) 'Tax Holidays as Signals,' American Economic Review 76 (4), pp.820-826; Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.57.

96 UNCTAD, *World Investment Report 2004*, *op cit*, p.3.

97 See S.C. Myers 'Determinants of Corporate Borrowing', 5 Journal of Financial Economics, pp.146-175; Michael C. Jensen and William Meckling (1976) 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', Journal of Financial Economics pp.305-360; Andrei Shleifer and Robert Vishny (1986) 'Large Shareholders and Corporate Control' Journal of Political Economy 94 (3) pp.461-488; and George Ackerof, (1970) 'The market for lemons,' Quarterly Journal of Economics 84, pp.488-500.

provide up-front funds, operate on a temporary basis and are targeted in a discretionary manner to domestic firms would be desirable.[98]

Developing economies tend to be characterised by low levels of efficiency in infrastructure. These inefficiencies sometimes are a legacy from previous colonial rule when inherited administrative systems were poorly structured and designed primarily to extract and transport natural resources to the seaports and not to connect domestic markets and communities.[99] Larger firms have the scope of operations to be able to deal with disincentives created by poor infrastructure. For instance, in countries where domestic electricity utilities are unreliable, it would be easier for larger firms to adapt by acquiring private, alternative sources of power. Microenterprises may find the challenges of coping with these difficulties in the business environment monumental or even insurmountable.[100]

Directly resolving failures in basic services by privatising inefficient utilities may create fewer distortions than incentives. However, where this cannot be done immediately due to political difficulties or the lack of adequate structures,[101] there may be a temporary role, albeit at the margin, for tax incentives to mitigate the challenges adverse operating environments pose for microenterprises.[102]

2.4.5. **Promoting Public Gains from Externalities**

Tax incentives are frequently used by policymakers to correct perceived market failures (e.g. free-rider problems and information asymmetries) which may result in a dearth of investment in high-tech industries, R&D and

98 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.55.

99 Particularly with African transportation networks: Commission for Africa, *Our Common Interest: Report of the Commission for Africa, op cit*, p.109.

100 Box 6.10 'The Power to Improve Productivity in Nigeria' in *World Development Report 2005*, *op cit*, p.132.

101 Like a comprehensive competition law policy, competitive services markets and enforcement institutions.

102 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.55.

environmentally friendly technologies. One of the greatest advantages of private investment is its potential to create positive externalities which exceed the returns 'captured' by owners of private capital.[103] Policymakers in developing countries often offer incentives for private investment to enhance associated public goods.

These outcomes differ fundamentally from the neoclassical counter-revolutionists' prescriptions that free-market reforms which reduce (or indeed, eliminate[104]) the government's role in the market place would lessen economic inefficiencies, distortions and rent-seeking.[105] While the notable failure of the state-controlled economies of the former Soviet Union underscores the greater efficiencies of free-market economies, there have been significant failures of free-market policy prescriptions in some developing economies.[106] These failures have been attributed in part to the conceptual foundations of much neoclassical counter-revolutionist thinking. The assumptions underpinning free, open and perfectly competitive markets may not be entirely applicable in the fundamentally different realities of developing markets, institutions and economies. In developing countries there may be a case for a genuine role for governments in making necessary economic interventions which promote general welfare, encourage the social benefits of increased investment and reduce the undesirable effects of free market-based reforms.[107]

Conversely, contemporary economic theories highlight the ability of externalities from consistent, complementary investments in human and physical capital to generate positive spillovers not captured by private investors which ultimately benefit the economy and contribute to sustained, long-term economic growth. For instance, endogenous growth theory, O-Ring

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103 *Ibid*, p.53.

104 In the case of the new political economy variant of public-choice theory which argues for no public or government intervention in the economy due to the corrupt activities of selfish, self-interested government functionaries and their rent-seeking private sector collaborators.

105 Todaro and Smith *Economic Development* (9th ed), *op cit*, p.121.

106 Joseph E. Stiglitz *Globalisation and its Discontents* (Allen Lane/Penguin Press, London: 2002), chapters 4 & 5.

theory and Big-Push economic model all recognise the capacity for minor distortions in markets and the behaviour of market participants to interact and create more significant, global distortions which may hamstring economic development. These economic models also support constructive government policy interventions to kick-start the process of development and provide the compulsion to lift developing economies out of poverty traps and cyclical underdevelopment.[108]

2.4.6. **Generating Employment & Controlling Urbanisation**

Unsustainable urbanisation is one of the most significant problems facing developing countries. Current population projections presage dire consequences should uncontrolled rural-urban migration remain unaddressed. At current projections, the global population is expected to exceed 9billion by 2050, increasing by 34% from current levels of 6.7billion souls. More disconcerting is the expectation that most of this growth is expected to be in the developing world where the population is set to increase from 5.7billion to 7.9billion between 2007 and 2050.[109]

Sub-Saharan Africa is currently the most rapidly urbanising continent.[110] The respective populations of Nigeria, South Africa are to grow from 158.313million, 49.278million and 40.645million to *288.696million*, *55.590million* and *84.757million* between 2010 and *2050*.[111] The growth rate of

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107 Todaro and Smith *Economic Development* (9th ed), *op cit*, pp.123-125.

108 See further Todaro and Smith *Economic Development* (9th ed), *op cit*, chapter 4; Michael Kremer (1993) 'The O-ring theory of economic development', Quarterly Journal of Economics, vol. 108, pp.600-621; Kevin M. Murphy, Andrew Shleifer, and Robert W. Vishny (1989) 'Industrialisation and the big push', Journal of Political Economy vol.97, pp.1003-1026; and Paul Krugman *Development, Geography, and Economic Theory* (MIT Press, Cambridge Massachusetts: 1995).

109 United Nations, World Population Prospects: The 2006 Revision Press Release POP/952 of 13/03/2007, available at <http://www.un.org/News/Press/docs//2007/pop952.doc.htm>.

110 United Nations Habitat Globalisation and Urban Culture Report on 'The State of the World's Cities: Trends in Sub-Saharan Africa', Urbanisation and Metropolisation, available at http://www.unchs.org/mediacentre/documents/sowc/RegionalAfrica.pdf on 23.08.05.

111 United Nations, World Population Prospects: The 2006 Revision Press Population Database available at <http://esa.un.org/unpp/>.

Lagos, Nigeria illustrates this frenetic pace of population growth. Its population exceeded 1million for the first time by 1970[112] but the 2006 national census figures exceed 9million inhabitants.[113] By 2015, Lagos may well be the third most populous city in the world with a population of 24.4million.[114]

Although such mega-cities come with some advantages, unchecked growth on the scale predicted pose serious human and environmental concerns for developing nations. The problem of urban congestion in developing countries is closely linked to labour market distortions, unemployment and low productivity.[115] Labour distortions are exacerbated by related phenomena including the unregulated growth of the informal sector and the growing number of educated but unemployed residents in megacities.[116]

One plausible explanation for rural-urban migration is the **Todaro/Harris-Todaro model** which considers the broader horizon some urban migrants would consider when choosing between the expected income in the rural areas and the present value of expected urban income over a longer-term, discounted for the increasing probability of urban migrants obtaining gainful employment over time in the urban areas.[117] These outcomes suggest that selective interventions, by way of wage subsidies and well targeted tax incentives may provide intermediate solutions to these difficulties. Tax incentives could also be granted for private investment in rural areas particularly for investment which improves basic infrastructure, promotes small-scale and labour-intensive 'cottage' industries, and fosters the development of technology appropriate to rural realities.[118]

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112 United Nations Habitat Globalisation and Urban Culture Report on The State of the World's Cities: Trends in Sub-Saharan Africa, Urbanisation and Metropolisation, *op cit.*

113 'Kano Tops Population Charts', *This Day* newspaper report, 10th January 2007 <http://www.thisdayonline.com/nview.php?id=67668> accessed 10.01.07.

114 Todaro and Smith *Economic Development* (9th ed), *op cit*, pp.314-315.

115 Deepak Lal and H. Myint, *The Political Economy of Poverty, Equity and Growth: A Comparative Study* (Clarendon Press, Oxford: 1996), pp.177,178;209-210.

116 Todaro and Smith *Economic Development* (9th ed), *op cit*, pp.330-333;345.

117 *Ibid*, pp.347-348.

118 *Ibid*, pp.314-315.

Some commentators have argued that while tax incentives may be useful as second-best interventions to remedy distortions in labour markets, a more basic solution would be to implement appropriate labour market policies.[119] However, the use of tax incentives as selective interventions would be particularly useful where efforts at implementing labour market policies are fraught with political or administrative difficulties. Tax incentives could also promote the development of 'edge cities' located outside the axis of urban agglomerations by directing the growth of the mega-urban area away from a congested centre.[120] Regional incentive schemes providing accelerated depreciation write-offs and other incentives to corporations investing in such sectors may prove attractive.

2.4.7. **Sectoral & Regional Incentives for Sustainable Development**

Tax incentives could be utilised in the promotion of vital economic sectors such as **agriculture**. While global average agricultural production has increased in tandem with growth in population, production in the Sub-Saharan African sub-region has lagged behind, resulting in periodic food shortages, famines and human suffering. The dearth of mechanised, modern farming techniques; inadequate biological inputs by way of hybrid and genetically enhanced seeds; poor irrigation systems; erratic climatic conditions and poor rains; ineffective means of combating pests; and the lack of cheap and widely available fertilisers have all contributed to low agricultural productivity.[121] Tax incentives which improve conditions for agricultural productivity may help address these challenges.

Similarly, other sectors have the capacity to improve the economic fortunes of Sub-Saharan Africa. **Small and medium sized enterprises** and **export-market industries** play important roles in improving incomes and increasing regional

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119 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries,' *op cit*, p.56.

120 Todaro and Smith *Economic Development* (9th ed), *op cit*, p.324.

121 *Ibid*, chapter 9.

industrial bases. Tax incentives could be utilised to improve the performance of firms and individuals in export-market manufacturing, tourism, information technology and other services. Efforts in the way of more mundane adaptation of technology to fit the peculiar circumstances of developing countries could also be encouraged by tax incentives.[122] Given the concentration of R&D expenditure in the developed world and the latent need in developing countries for simple products targeted at local problems, a greater emphasis on capital-saving technological initiatives is desirable.[123] Finally, governments must not overlook the need for **sustainable development** and the preservation of the **environment**. Efforts to adopt environmental accounting[124] and conform to sustainability guidelines such as the Equator Principles[125] have assisted in redressing the depletion of environmental capital by projects in the developing world. Tax incentives targeted at extractive industries may provide support for the introduction of new, environmentally-friendly technologies.[126]

§2.4 has highlighted some of the uses to which tax incentives have been applied in developing countries. From offsetting the corporate tax distortion to controlling rapid urbanisation, policymakers seek to achieve various economic and social ends by wielding these tools. However, tax incentives have certain drawbacks as seen next in **§2.5**.

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122 E.g. full expensing of and multiple deductions for R&D expenditures, investment tax credits and allowances, tax holidays, export processing zones, high technology clusters and science parks: World Bank, *World Development Report 2005*, *op cit*, pp.173-174.

123 Todaro and Smith *Economic Development* (9th ed), *op cit*, pp.77,99.

124 Factoring the implications and consequences of environmental degradation into evaluating the costs and benefits of projects.

125 See further: <http://www.equator-principles.com/index.html>.

126 See below at **§3.2.2.1.6**.

2.5. THE DEBATE OVER THE EFFICACY OF TAX INCENTIVES

2.5.1. Overview

The previous sections have examined the definition and nature of tax incentives, considered various types of incentives and noted possible roles in achieving sustainable economic development. Early economic studies analysing the efficacy of tax incentives consider their use in attracting FDI to developing economies. Numerous findings were made using evidence from selective surveys of multinational companies and time-series econometric analysis. In the main, these surveys[127] indicated that while tax incentives might have some incentive value, this tended to be at the margin and was secondary to more fundamental economic factors.[128] Time-series econometric studies evaluated the sensitivity of FDI to variations in tax rates using regression analyses[129] and found that market and political considerations tended to outweigh the effect of any tax policy issues.[130]

However, as demonstrated by the 1980s' literature on FDI, tax incentives sometimes have a real and decisive effect on investment decisions. This finding is valid particularly regarding the location of projects within a geographic region; export-market oriented production, especially for highly competitive, high volume/small margin businesses; mobile, 'footloose' multinational groups which have a wide range of alternative investment sites; small, start-up enterprises which may suffer from cash constraints; and banking, insurance and other financial firms engaged in sophisticated tax avoidance/planning strategies.[131] Later empirical studies scrutinising actual investment decisions

127 By Barlow and Wender (1955); by Robinson (1961); by Aharoni (1966); and by the Group of Thirty (1984). More detailed investors surveys were conducted by Ernst & Young in 1994, by Deloitte Touche in 1997 and the Japan External Trade Organisation in 1995.

128 Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review', *op cit*, pp.76-77.

129 However, the drawbacks of these studies include the inability of aggregate data to differentiate between other trade and policy factors that could influence FDI flows and difficulties in determining which classifications to adopt and how to interpret analytical results.

130 Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review', *op cit*, pp.69-108.

131 *Ibid*, pp.82-83.

seem to support these conclusions particularly for investors with alternative sites in view or whose ventures target export-market opportunities.[132]

Some theoretical studies[133] on the effect of tax incentives on hypothetical investments projects calculate the financial impact of tax incentives on expected returns based on the traditional economic assumption that all investors behave in simple, profit-maximising ways. These studies find that tax incentives may influence investment decisions in the selected scenarios. Many of these studies use *marginal effective tax rates* which measure the tax collected by revenue authorities on marginal investments to determine the sensitivity of investment to changing tax burdens induced by tax incentives. Marginal effective tax rates tend to perform this function better than other alternative tools such as average effective tax rates and rate-of-return calculations, hence their preference by some commentators.[134]

Auerbach criticises the use of marginal effective tax calculations by some scholars and argues that unless certain adjustments are made[135] these calculations may be erroneous.[136] Mintz analyses the incentive effect on the cost of capital and effective tax rate of firms in periods during and after tax holidays.[137] His findings reveal that tax holidays would be effective only to the extent to which depreciation allowances and tax losses are deferred to post-

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132 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, pp.17-19.

133 Auerbach, 'The Cost of Capital and Investment in Developing Countries,' in *Fiscal Incentives for Investment and Innovation, op cit*, pp.137-139; Jack Mintz, 'Tax Holidays and Investment,' in *Fiscal Incentives for Investment and Innovation, op cit*, pp.165-193; Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries' *op cit*, pp.131-136.

134 *Ibid*, pp.58-59.

135 I.e. assessing the tax wedge between the required rate of return and the return to investors after *all* taxes; making allowances for the extent that such taxes are borne by imperfectly immobile factors of production; trade-offs between incentives which lower tax burdens but also lower tax transfers from residence to source countries; the effect of gross return/local and international pricing models; and the operation of complex tax incentives.

136 Auerbach argues for more general cost of capital models and the analysis of dynamic, non-corporate tax considerations: Auerbach, 'The Cost of Capital and Investment in Developing Countries' *op cit*, pp.137-164.

137 Mintz, 'Tax Holidays and Investment', *op cit*, pp.165-193.

holiday periods. However, investment tax credits and allowances would equally induce investment in long-term, durable capital without the large revenue costs associated with tax holidays.[138]

These theoretical results have been criticised as being too simplistic for failing to take account of the complexities of real investment decisions. Modern multinational concerns have at their disposal sophisticated tax planning tools that could render their investment responses to source country tax policies complicated and opaque to policymakers relying on simple tax calculations and scenarios. [139] Finally, research into how managers make real investment decisions indicate that simple profit-maximising models of rational decision-making may overlook more complex, 'satisficing' behaviour that may be more consistent with the commercial realities of long-term, strategic decision-making.[140]

2.5.2. **Pro-Tax Incentives Arguments**

The debate over the use of tax incentives has generated conflicting views with the pro-incentive school contending that these measures increase aggregate investment and can positively influence the spatial distribution of capital accumulation. Many of the possible roles served by tax incentives considered above are used to justify such selective interventions. [141] These arguments would not be repeated here. The next section examines various reasons canvassed by critics of tax incentives.

2.5.3. **Criticism of Tax Incentives**

2.5.3.1. **Overview**

The case for the anti-tax incentives school may be summarised by two general arguments. Firstly, these measures have little, if any incentive value: they do

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138 *Ibid*, pp.190-191.
139 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, pp.16-17.
140 Brealey and Myers *The Principles of Corporate Finance* (5th International Edition), *op cit*, pp.992-993.
141 See §**2.4** above.

not affect the decisions of local or foreign investors and (in respect of tax incentives for FDI) are wasteful in that they effectively 'rob (local) taxpayers to pay the (international) investors'. Alternatively, tax incentives are not cost-effective in that the revenues forgone typically exceed direct and indirect benefits from related investment.[142] These criticisms are considered below.

2.5.3.2. Erosion of Narrow Tax Bases

Some commentators have criticised the use of tax holidays and other incentives in developing countries as these tend to erode tax bases. Aggressive tax avoidance or unscrupulous tax evasion schemes could be used to shift taxable income from tax-holiday firms to tax-paying firms within a single group. Administrative lapses could result in falsified or non-existent records hampering revenue collection and monitoring activities in post-tax holiday periods. Additional burdens may be imposed on tax-paying firms to make up the revenue forgone.[143] Developing countries tend to be more reliant on corporate and trade taxation than on personal income taxes. Consequently, tax incentives which affect these taxes tend to reduce the already narrow tax bases of such developing countries.[144]

2.5.3.3. Cost-Benefits Analyses

The cost implications associated with different types of tax incentives vary considerably. Accelerated depreciation and investment tax credits/allowances may be preferable to investment subsidies and tax holidays given the quantum of revenues forgone.[145] Where benefits in terms of incremental investment and positive externalities are elusive or difficult to measure, decisions granting tax incentives to certain industries or firms may be opaque and not lend themselves to either public scrutiny or administrative review. Wells and Allen estimate tax incentive costs by comparing the revenue lost by the provision of

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142 Wells *et al, Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs? op cit*, p.vii.

143 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, pp.25-26.

144 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, pp.299-322.

incentives to firms which did not require them to invest, with the incremental investment made by firms that required incentives and invested as a result. By the use of subsidy equivalents and redundancy rates, these researchers suggest that the actual costs of providing incentives may sometimes exceed the net present value of incremental investment.[146]

Revenue authorities that lack adequate systems to identify and quantify the positive externalities desired from incremental investments may make flawed decisions based on the absence of a comprehensive assessment of the dividends of investment against which to compare the costs. Where administrative systems are necessary to supervise the operation of tax incentives, the costs of these systems when they work well (and indeed, when they are abused) must be borne in mind.[147] Tax incentives may also lead to unanticipated and undesirable side-effects. Some tax incentives may promote short-term, less enduring investment over longer term, more desirable types defeating the actual intentions of policymakers.

2.5.3.4. **Selecting Winners from Firms & Sectors**

Predicting which sectors would be deserving of tax incentives and selecting winning firms is more an art than a science: an art which governments have often failed spectacularly at. Examples abound of 'ugly ducklings' overlooked by governments which turned out to be viable geese laying golden eggs.[148] Conversely, governments have been known to bet on the wrong sectors and failing firms, supporting such investments with expensive incentive packages despite evidence indicating that initial investment decisions were flawed.[149]

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145 *Ibid*, pp.316-318.

146 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments' *op cit*, pp.21-24.

147 Morisset and Pirnia 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review', *op cit*, pp.94-95.

148 E.g. horticulture in Colombia and Kenya; textile manufacturing in Bangladesh; software development and services in India; and automobiles in Japan: World Bank, *World Development Report 2005*, *op cit*, p.160.

149 E.g. the SOTEXKA (Senegal) and ALSCON (Nigeria): see Box 8.2 'Picking "winners" can be an expensive gamble – SOTEXKA in Senegal', *ibid*; B. Olowo (May 2001) 'Nigeria Attempts a Fresh Start', Metal Bulletin Monthly Vol. 365, pp.52-54.

In today's competitive and dynamic global environment, firms leaving traditional areas of comparative economic advantage assume great risks which may pay off tremendously if the ventures are successful or lead to business failure if ill-advised. Firms which miscalculate merely stand to lose their shareholders' and creditors' funds. However, where failing firms or sectors are subsidised by tax incentives, they unduly benefit from the cushion of taxpayers' funds which would be better utilised supporting successful firms or directly improving the investment environment. Certain types of tax incentives reduce transparency in assessing these implicit costs to the public purse. Indeed, where incentives are provided to sectors whose outputs serve as substitutes for outputs produced by other sectors which do not enjoy incentives, distortions may result leading to undesirable outcomes.

2.5.3.5. **Reducing Corruption & Undesirable Conduct**

Tax incentive policymakers typically include government authorities, executive ministries, legislative authorities and independent regulators who all policymakers should (ideally) be guided by the greater public good. However, as the literature on political economy indicates, the allocation of resources and economic opportunities by institutional processes may be subverted by powerful elites exerting pressure for policies which exclusively favour them.[150] Corruption is fostered where public power held on trust for the many is abused for the private benefit of the few.

Tanzi has identified certain conditions which lend themselves to the proliferation of corrupt practices in tax and customs administrations.[151] These include ambiguous laws; tax systems requiring regular contact between taxpayers and tax administrators; poor remuneration of tax officials; tolerant attitudes to corrupt behaviour in tax administration; opaque administrative

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150 Shah, 'Overview' in *Fiscal Incentives for Investment and Innovation*, *op cit*, p.36; Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.6.

151 Vito Tanzi *Policies, Institutions and the Dark Side of Economics* (Edward Elgar, Cheltenham: 2000), pp.110-113.

procedures; administrative discretion over significant decisions; and poor administrative oversight. It is instructive to note that many of these conditions typically occur in developing countries and may impair the success of incentive schemes executed through such flawed administrative systems. Similarly, rent-seeking could pervert tax incentives and transfer gains from selective interventions such as tax incentives, high tariffs and import quotas from taxpayers and consumers to small cliques of elites.[152]

2.5.3.6. **Agency Problems & Prisoners' Dilemma**

Wells and Allen have identified certain agency problems that may arise from the design and implementation of tax incentives.[153] These problems are aggravated where revenue costs associated with incentives are imputed to fiscal authorities and not the relevant investment promotion agency. Studies on Indonesian tax incentives suggested that agency problems in the struggle for bureaucratic power. Power dynamics involving foreign investors were found to hinder a more dispassionate assessment of the costs of incentives against actual and perceived benefits.

Wells and Allen argue that investment promotion agencies and tax authorities need to be mindful of the hidden costs of incentives and ought not to be persuaded by the arguments of investors who bargain for incentives which they do not really require. Policymakers should also avoid pitfalls associated with competing with neighbouring countries to offer incentives. Wells and Allen warn of a prisoners' dilemma scenario whereby foreign investors obtain incentives in excess of what would have been conceded in the absence of cut-throat incentive competition. In these scenarios, the eventual outcome is to the detriment of all competing host (source) countries particularly the country that supposedly 'won' the contest.

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152 World Bank, *World Development Report 2005*, *op cit*, p.161.

153 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, pp.27-31.

2.5.3.7. **Pitfalls in Discretionary Triggering Mechanisms**

The effectiveness of tax incentives in achieving desirable economic outcomes may well depend on the mode of administration adopted. This is particularly true for discretionary or automatic incentives. The proper classification of incentives may be a question of degree, as most incentive schemes typically feature characteristics of both types. Incentives may be granted by the relevant authority on a discretionary basis after the evaluation of the firm or project based on subjective considerations. Here, the grant of incentives is entirely contingent on administrative fiat with the relevant authority being empowered to interpret policies or approve incentives in an *ad-hoc* manner.[154]

Conversely, under automatic administration regimes, once candidates meet a set of specific, objective and well-defined qualifying criteria, incentives are granted as a matter of course. The powers of the approving authorities are usually limited to verifying that the requisite criteria as regards quantum of investment in priority industrial sectors, transfer of technology, novelty of enterprise and use of local content or labour are met. Automatic incentives are preferred in the literature as there tends to be less uncertainty, shorter planning and processing periods, smaller administrative costs and less scope for graft. In special circumstances discretionary incentive approvals could improve the ability of the administrative body to select and approve the projects and firms most in line with the spirit of broader development policy. However, the practical disadvantages associated with such flexibility in terms of undesirable graft and rent-seeking lead most commentators encourage the use of automatic triggers wherever possible.[155]

In their study of Indonesia's re-introduction of tax incentives in 1996, Wells and Allen were highly critical of the *ad-hoc*, discretionary manner of

154 Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.318.

155 Boadway and Shah, 'Perspectives on the Role of Investment in Developing Countries', *op cit*, p.36; Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.318.

administration adopted.[156] The approving panel was ineffectual as most decisions were made by presidential fiat for favoured associates without clear underlying business justifications or economic rationales. Although the new incentives were intended to benefit electronics firms, grants were still made to other ineligible businesses. Incentives were awarded on a project-by-project basis and this reduced transparency. It also increased the costs of investors dealing with uncertainty, conducting feasibility studies and meeting information requirements. Consequently, Wells and Allen conclude that discretionary incentives are flawed as they are prone to corruption, cronyism and political influence particularly in developing countries with weak governance controls.

2.5.3.8. Diversion of Attention from Other Development Activities

Investors choose the location of investments based on numerous factors. The existence of favourable, stable political and economic policies, efficient utilities, adequate physical and intangible infrastructure, liberal and open attitudes to investment, a well-educated work force, attractive geographic location and proximity to factor and output markets can make all the difference.[157] Where these fundamentals are lacking, policies seeking to compensate for any disincentives may be of little moment. Some commentators have criticised the use of 'quick fix' tax incentives where these divert the attention of policymakers away from harder, more fundamental efforts to improve the local investment climate.[158]

2.5.3.9. International Tax Law Interactions Between Tax Systems

Finally, the actual operation of tax incentives for FDI in developing countries may depend on the complicated interaction of source (home) country and

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156 Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*.

157 See Box 7.2 'Why Intel choose Costa Rica as the site of a multimillion dollar plant' World Bank, *World Development Report 2005*, *op cit*, p.139.

158 E.g. liberalising markets, improving tangible and intangible infrastructure, reducing bureaucratic red-tape and other barriers to investment, industry and innovation: Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, p.26.

residence (host) country tax rules.[159] Where capital-importing countries design and implement tax incentive schemes without due regard for these interactions, undesirable and unintended outcomes could result such as providing redundant or excessive incentives and reducing (or indeed, reversing) tax transfers from residence to source countries resulting in 'aid-in-reverse'.[160] These issues are examined in greater detail in Chapter 6.

159 Shah, 'Overview' in *Fiscal Incentives for Investment and Innovation, op cit*, p.36; Tanzi and Zee 'Tax Policy for Emerging Markets: Developing Countries' *op cit*, p.15.

160 Viherkenttä, *Tax Incentives in Developing Countries & International Taxation, op cit*, pp.1-5; Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments', *op cit*, p.8.

2.6. OUTCOMES

This Chapter has considered the concept of tax incentives, described the various types utilised and evaluated contradictory views in the debate over their efficacy in promoting sustainable economic development. It would appear that there is no unequivocal answer to the query 'do tax incentives work?' While tax incentives have the potential to trigger sustainable investment and economic growth, as with other kinds of selective interventions, the design and implementation of tax incentives usually determine their success or failure.[161] Where prudently designed tax incentives are implemented with integrity and continuously reviewed, they stand a better chance, in conjunction with other more direct policies, to improve the investment climate. Although such improvements may be at the margin, marginal economic growth, if sustained, may well have the propensity to ignite development and propel developing economies out of a downward spiral of poverty and underdevelopment.

Much of the literature on tax incentives considers their role in attracting FDI usually from Western, capital-exporting countries. This bias is understandable given the quantum of such FDI and the familiarity of many contributing authors with the tax systems of developed nations. This Thesis does not seek to replicate the general, FDI-oriented and econometric-based approaches adopted in many of these studies. Rather, by critically considering the actual and perceived role tax incentives play in fostering sustainable economic development in Nigeria, South Africa and Kenya, this Thesis seeks to offer a distinct and original insight to the operation of tax incentives in Sub-Saharan Africa. The themes introduced above shall be expanded upon in detailed analyses of local laws, institutions and conditions. The next Chapter comprehensively examines the legal regime for tax incentives in the Federal Republic of Nigeria.

161 World Bank, *World Development Report 2005*, *op cit*, pp.162-163.

3. AN EXPOSITION OF NIGERIAN TAX INCENTIVES

"The greatest threat to freedom is the absence of criticism." [162]

3.0. INTRODUCTION

3.0.1. Proem

This Chapter reviews Nigerian fiscal policy within the context of its historical, political and legal setting. It provides an original exposition of the Nigerian legal regime for tax incentives. Taking a sectoral approach, it systematically catalogues existing tax incentives applicable under Nigerian law. This exposition is based on bibliographical research on Nigerian tax incentives as well as practical perceptions from numerous interviews of leading Nigerian public officials, lawyers, accountants and professionals conducted during Nigerian Field Trips in November 2005 and January/February 2007. It forms the backdrop against which the South African and Kenyan tax incentive practices highlighted in the succeeding Chapters 4 and 5 may be compared. Chapter 3 also complements the critical analysis of contemporary Nigerian tax incentive policy using exemplars derived from the South African and Kenyan experiences in Chapter 7.

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162 Quote attributed to Professor Wole Soyinka, the Nigerian playwright, author, dissident and winner of the 1986 Nobel Prize for Literature.

3.0.2. **Historical & Political Development of Nigeria's Legal System**[163]

Much of the origins of the Nigerian legal system lie in the early interaction and subsequent fusion of indigenous customary and religious (Islamic) legal systems with English law introduced by the British. Written Islamic law was in force in the northern regions of what was to become Nigeria whilst unwritten customary law was prevalent in the South. However, due to the profound impact of colonial rule on Nigeria's evolution from numerous distinct emirates, chiefdoms and ethnic groups it is hardly surprising that the Nigerian legal system has English common law as its core.

English common law, doctrines of equity and statutes of general application in force in England on 24 July 1874 became applicable with the establishment and reorganisation of the Colony of Lagos between 1862 and 1876. A similar legal system existed in both the Protectorates of Southern Nigeria and Northern Nigeria, though the relevant statutes of general application were those in force in England as at 1 January 1900. The Colony and Protectorate of Lagos was first merged with the Protectorate of Southern Nigeria in 1906 to form the Colony and Protectorate of Southern Nigeria, and the Northern and Southern Protectorates were eventually united on 1 January 1914 to form the Colony and Protectorate of Nigeria.

Nigeria was reorganised as a federation in 1954 and attained independence on 1 October 1960. With the adoption of the 1963 Constitution, the British regent (Her Majesty Queen Elizabeth II) was replaced by the new President (Dr. Nnamdi Azikiwe) as Head of State. Similarly, the Judicial Committee of the Privy Council was replaced by the Federal Supreme Court as the highest court in the land. Legislative powers were shared between the federal Parliament and regional Legislatures, with the former being competent to make laws (or 'Acts') in respect of matters on the Exclusive Legislative List and the latter authorised to make laws (or 'Laws') on matters on the Concurrent Legislative List.

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[163] See generally Prof. Akintunde Obilade's seminal work on the Nigerian legal system: A.O. Obilade *The Nigerian Legal System* (Sweet & Maxwell, London: 1979), Chapter 2; see also T.O. Elias, *The Nigerian Legal System* (Routledge & Paul, London: 1963).

Latent ethnic and religious tensions soon produced rends in the nation's fabric with both disturbances in the Western Region and the fallout of a controversial census leading to violent riots and widespread political unrest. An era of extended military rule began with the armed revolution of 15 January 1966 and the counter-revolution of 29 July 1966. The Constitution was suspended and the Regions were replaced first with a union of Provinces and later by a federation of 12 states. Legislative power was vested in the central Federal Military Government which could make laws (or 'Decrees') for the whole or any part of Nigeria. Military Governors were appointed for the various Regions (later, states) and made laws (or 'Edicts') *vis-à-vis* matters on the Constitution's Concurrent List with the prior consent of the Head of State. Gen. Yakubu Gowon, as Head of State, was empowered to appoint the Chief Justice of Nigeria and other judicial officers. Consequently, the principle of constitutional separation of powers was undermined.

Unfortunately, the unstable political situation soon degenerated into a civil war between 1967 and 1970 in which over a million souls were lost to the fighting and famine. The Biafran secession was eventually repressed and the secessionist Ibo people were reabsorbed into Nigeria upon the surrender of the Biafran army to Col. Olusegun Obasanjo on 15 January 1970. Gowon was overthrown on 29 July 1975 by a *coup d'état* which brought Gen. Murtala Mohammed into power. Mohammed was assassinated in a subsequent coup attempt on 13 February 1976. Gen. Olusegun Obasanjo succeeded him and implemented significant social and legal reforms. One of Obasanjo's legal reforms was the introduction of a new Presidential-style Constitution which concentrated power in the federal government. Obasanjo restored democratic rule by handing power to Alhaji Shehu Shagari after controversial elections in 1979. The 1979 Constitution remained in force though frequently modified over the next 15 years by successive military juntas lead by the following generals: Muhammadu Buhari, Ibrahim Babangida, Sani Abacha and Abdulsalami Abubakar.

Under Abubakar's regime a new constitution, the Constitution of the Federal Republic of Nigeria 1999 (hereafter: CFRN 1999) was introduced. CFRN 1999 allocates legislative powers between the federal (central), state (regional) and local (municipal) Governments. Abubakar ruled for 9 months and organised democratic elections which were won by retired Gen. Obasanjo and the Peoples Democratic Party (or PDP). Obasanjo was sworn in as a civilian President on 29 May 1999 and ruled for 8 years, having being re-elected in 2003. In May 2007, Obasanjo was succeeded by the current President Umaru Yar'Adua (also of the PDP) after controversial elections.

This section (§**3.0.2**) has outlined some aspects of the historical evolution of the Nigerian legal and political system as a background to contemporary economic and fiscal policy. The next section sets out the key characteristics of the Nigerian tax system within which fiscal incentives operate.

3.1. THE NIGERIAN TAX SYSTEM

3.1.1. Historical Development of Taxation in Nigeria

Ayua [164] observes that the use of taxation to finance public expenditures in Nigeria predated British colonial rule. Ayua notes the use of organised taxation [165] in the ancient (Kanuri) Borno-Kanem kingdom and (Hausa-Fulani) Sokoto caliphate in the North and the monarchies of the southern Yoruba and Benin kingdoms. It appears that organised systems of taxation were largely absent among the ethnic groups of the Middle-belt and Eastern parts of Nigeria which were politically organised around kinship clans and lacked traditional monarchs.[166] Tax due was paid in coinage or kind (typically tributes and personal services) though the latter featured more prominently in the northern regions.

Modern taxing systems were introduced by the British who consolidated traditional taxes in the Northern Protectorate of Nigeria under the *Land Revenue Proclamation*.[167] Taxing statutes were gradually introduced in the Western and Eastern Regions in 1917 [168] and 1927 [169] respectively taking account of the financial costs of administrative burdens borne by the regional and local governments. In the Western Region, the challenge of ensuring sufficient funds for local governments led to the grant of new taxing powers to the local

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164 I.A. Ayua, *Nigerian Tax Law* (Spectrum Law Publishing, Ibadan: 1999), chapter 2.

165 Including early taxes on agricultural commodities (*kurdin kasa*, *shuka-shuka* on crops exempt from *zakat* and *jangali* on lifestock) and the charitable *zakat* (a tax levied to fund educational or religious endeavours): *ibid*, p.22.

166 Consequently, there was little need to expropriate private resources to maintain an emirate or kingdom. Traditional social expenditures were funded by contributions solicited by clan leaders.

167 A major consideration behind the merger of the Protectorates was that the landlocked northern regions lacked sufficient tax capacity: Oluwole Akanle, *The Power to Tax and Federalism in Nigeria: Legal and Constitutional Perspectives on the Sources of Government Revenue* (Intec Printers Limited, Ibadan: 1988) pp.11-13, particularly footnote 5; F.D. Lugard, Report on the Amalgamation of Northern and Southern Nigeria, and Administration 1912-1919, Cmd. 468.

168 Under the *Native Revenue Ordinance* of 1917: C.S. Ola, *Historical Development of Tax System in the Western State of Nigeria, 1957-58 to 1973-74* (Government Printer, Western State of Nigeria, Ibadan: 1974), p.1.

169 Under the *Native Revenue Ordinance* of 1927. See also Caroline Ifeka-Moller, 'Female Militancy and Colonial Revolt: The Women's War of 1929, Eastern Nigeria' in Shirley Ardener (ed) *Perceiving Women* (London Malaby Press, London: 1975).

Councils.[170] In the Eastern Region, collections of taxation targeted at particular social purposes such as education appear to have met with more success and less resistance.[171] Personal and corporate[172] income taxes were later introduced and the application of the relevant taxing statutes was extended to cover the entire nation.[173]

Problems with assessing income to tax based on residence[174] were eventually resolved by taxing incomes accrued in, derived from, received in or brought into Nigeria from whatever source at the regional level. This trend towards the devolution of unitary taxing powers away from the central government was borne out of various constitutional arrangements[175] which sought to deepen the foundations for a truly federal division of taxing powers. However, since Independence the federal autonomy of the states *vis-à-vis* taxing powers have been greatly reduced due to the strong unitary tendencies re-introduced by the military's incursion into political rule and consolidated by the 1979 and 1999 Constitutions.

The reduced fiscal autonomy of the states has been accentuated by the post-1970s dominance of revenues from the industrial and energy sectors in public finance. Consequently, the Nigerian economy tends to exhibit characteristics of a 'rentier state' which occur where the convenient taxation or economic exploitation of economic rents derived from a single, well-endowed and typically extractive economic sector generates sufficient revenues for the government to finance public expenditures without significant recourse to the taxation of other industries or incomes. Rentier theorists associate the ease

170 Ola, *Historical Development of Tax System in the Western State of Nigeria*, *op cit*, chapter 1.
171 *Ibid*, p.5.
172 Taxation on corporate profits was imposed by the *Income Tax Ordinance No. 3 of 1940* which taxed the income of expatriates (previously imposed under the *Non-Native [Protectorate] Ordinances* of 1931 and 1939) and indigenous persons resident in Lagos.
173 Under the *Direct Taxation Ordinance No. 4 of 1940*.
174 E.g., the Lagos source income of a person resident in the Western Region was exempt from tax and *vice-versa*: Ola, *Historical Development of Tax System in the Western State of Nigeria*, *op cit*, p.2.
175 Akanle, *The Power to Tax and Federalism in Nigeria: Legal and Constitutional Perspectives on the Sources of Government Revenue*, *op cit*, pp.14-15.

with which such governments obtain financial resources to finance public expenditure with low political and democratic development due to the reduced accountability of such governments to their peoples. Where such governance flaws coincide with Dutch disease, a resource curse results: the country's currency becomes overvalued, real economic sectors become internationally uncompetitive and the balance of trade position becomes negative.[176]

Presently, the federal government dominates public entrepreneurial participation in the energy sector and the taxation of corporate profits from petroleum companies. While a percentage of revenues accruing to the federal government is redistributed to the states and local governments under the relevant constitutional provisions,[177] responsibility for economic policy, public finance and taxing powers are concentrated in the federal government with the federating states and local authorities being in a weaker position.[178]

3.1.2. Taxing Powers, Tax Administration & Dispute Resolution

The **power to impose tax** is shared between federal government, the federating states and the local governments in accordance with the CFRN 1999. Matters under the Exclusive Legislative List[179] are within the sole preserve of the National Assembly.[180] This absolute federal legislative competence covers the following matters: customs and excise duties,[181] export duties,[182] stamp duties,[183] the taxation of incomes, profits and capital gains,[184]

176 Axel Harneit-Sievers, 'Reforming the Rentier State: Some Thoughts on NEEDS' in S. Amadi and F. Ogwo (eds) *Contextualising NEEDS Economic/Political Reforms in Nigeria: A Report of Civil Society Policy Dialogue on the National Economic Empowerment and Development Strategy (NEEDS)* (HURILAWS & CPPR, Lagos: 2004), pp.xi-xix; K.A. Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East* (Cornell University Press, Ithaca: 1997).

177 §§80-82 of the CFRN 1999.

178 Akanle *The Power to Tax and Federalism in Nigeria: Legal and Constitutional Perspectives on the Sources of Government Revenue*, *op cit*, chapter 4; B.O. Nwabueze, *Federalism under the Presidential Constitution* (Sweet & Maxwell, London: 1983), chapter 11.

179 §4(1)-(5) and Part I of the Second Schedule, CFRN 1999.

180 Composed by the Senate and Federal House of Representatives.

181 Item 16, Part I, Second Schedule, CFRN 1999.

182 Item 25, *ibid*.

183 Item 58, *ibid*.

184 Item 59, *ibid*.

matters of general trade and commerce,[185] the conduct of external affairs and implementation of certain treaties.[186] The federating states' legislative powers are generally constrained to matters indicated on the Concurrent Legislative List [187] and matters not mentioned on either the Exclusive or Concurrent Legislative List.[188] The state and local governments also have powers to collect and administer certain taxes.[189]

The *Taxes and Levies (Approved List for Collection) Act of 1998* (hereafter: *Taxes & Levies Act 1998*) introduced some clarity into the regime of tax collection by the three tiers of government with the federal government being responsible for certain corporate taxes, value added tax, stamp duties, and certain taxes on capital gains and incomes. The main federal income taxes are corporation tax under the *Companies Income Tax Act No. 28 of 1979* (hereafter: CITA 1979) and personal income tax under the *Personal Income Tax Act No. 104 of 1993* (hereafter: PITA 1993). State governments are empowered to collect taxes on certain individuals' incomes, certain entertainment taxes, road taxes, business registration fees and certain land use charges.[190] At the lowest level, local governments were given powers to collect an eclectic collection of minor levies ranging from marriage, birth and death registration fees to parking charges.[191] However, as Sanni observes[192] CFRN 1999 remains the supreme law of the land

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185 Inclusive of both the import and export of commodities across Nigerian national borders and inter-state trade and commerce: see item 62, *ibid.*

186 Namely those relating to matters on the Exclusive Legislative List: items 26 and 31, *ibid.* As such, the implementation of laws to give effect to international obligations under tax treaties concluded with other nation states is a matter of federal competency.

187 To the extent that such state legislation is not inconsistent with any federal legislation on the same matter: §4(6)-(7) and Part II of the Second Schedule, CFRN 1999.

188 Under the so-called 'Residual' Legislative List: O. Akanle, *The Government, the Constitution and the Taxpayer* in M.A. Ajomo (ed) Tax Law and Tax Administration in Nigeria, Vol. 1, NIALS Conference Series (Nigeria Institute of Advanced Legal Studies, Lagos: 1991) p.9; Nwabueze *Federalism under the Presidential Constitution, op cit*, p.39. See also *Aberuagba's case* (1985) 1 NWLR 395.

189 See items D7-D10, Part II of the Second Schedule, CFRN 1999.

190 Part II of the Schedule to the *Taxes & Levies Act 1998.*

191 See Part III, *ibid.*

192 Abiola Sanni 'Division of Taxing Powers' in M.T. Abdulrazaq (ed) *C.I.T.N. Nigerian Tax Guide and Statutes* (1st ed., Chartered Institute of Taxation of Nigeria, Lagos: 2002) p.665.

and where the *Taxes & Levies Act 1998* is inconsistent with CFRN 1999,[193] it is void to the extent of such inconsistency.[194]

Tax administration similarly reflects the federal character of Nigeria with various federal and state bodies[195] sharing power over various facets. Local Government Revenue Committees[196] and State Boards of Inland Revenue,[197] collect the taxes and penalties dues to these respective governments. Similarly, federal taxes[198] are administered by the Federal Board of Inland acting through its operational arm, the Federal Inland Revenue Service (hereafter: FIRS).

The Federal Board of Inland Revenue[199] and its Technical Committee[200] are composed of civil service functionaries from the Ministry of Finance, the National Revenue Mobilisation Allocation and Fiscal Commission, the national oil company, the National Planning Commission, the Customs Service and the Corporate Affairs Commission.[201] The Board's broad remit extends to the implementation of tax incentives. Other bodies such as the National Council of Ministers, the Nigerian Investment Promotion Commission and the Nigerian Export Promotion Council also play notable roles in administering tax incentive laws.

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193 The *Taxes & Levies Act 1998* appears to suggest that the legislative powers of the National Assembly and state Houses of Assembly are strictly limited to the matters set out in its Schedule. Under the present democratic dispensation, the *Taxes & Levies Act 1998* (originally a federal decree) assumes the status of an Act of the National Assembly and is thus inferior to the CFRN 1999: §315, CFRN 1999.

194 §1(1) CFRN 1999.

195 §86 PITA 1993.

196 §§90-93 PITA 1993.

197 §§86-89 PITA 1993.

198 *Viz.*, capital gains tax, companies income tax, education tax, petroleum profits tax and VAT. However, commissioners of stamp duties are usually responsible for stamp duties.

199 §1; Part I, CITA 1979.

200 §2 CITA 1979.

201 §1 CITA 1979.

The **resolution of disputes** over tax imposition, assessment and collection are determined by various tribunals,[202] bodies[203] and courts. Here too, a federal-state dichotomy exists. Civil[204] and criminal[205] disputes in respect of federal revenue, corporate and business taxation, customs duties, excise and export duties, banking and finance, corporate bodies and the administration and management of federal agencies are determined at first instance by the Federal High Court [206] to the exclusion of all other courts. Under previous constitutions, the State High Courts had wider jurisdiction to determine matters; under CFRN 1999 this matter has been placed beyond cavil.[207] State High Courts[208] (and the High Court of the FCT, Abuja)[209] may only consider civil and criminal matters subject to the jurisdiction of the Federal High Court.

In practice, the State High Courts have jurisdiction over matters on which the state legislatures have legislative competence or which relate to the acts of state governments/agencies and which do not otherwise conflict with federal jurisdiction. Appeals from decisions of the Federal[210] and State High Courts lie to the federal Court of Appeal[211] and from there, to the federal Supreme Court. [212] While the courts are crucial in the interpretation of tax and

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202 For instance, VAT disputes are heard by the Zonal VAT Tribunals from where appeals lie to the Federal High Court: see *Value Added Tax Tribunals Rules, S.I. No. 14 of 2003* especially Order 16-Appeals.

203 Unresolved disputes over corporate tax assessments are decided at first instance by the Body of Appeal Commissioners from which appeals may be made to the Federal Court High Court: §§71-75, CITA 1979.

204 §251(1) CFRN 1999.

205 §251(3) *ibid.*

206 Originally established as the Federal Revenue Court with limited jurisdiction over causes and matters including corporate taxation, customs and excise duties, banking, admiralty, companies and corporate bodies: see *Federal Revenue Court Act No. 13 of 1973.*

207 As with the division of taxing powers, extended military's rule led to the concentration of judicial power in the federal judicial bodies. As such, State High Courts' previous jurisdiction over federal laws and bodies has been severely curtailed even where state governments and their agencies are involved: I.E. Sagay, 'The Judiciary in a Modern Democracy' in I.A. Ayua, D.A. Guobadia and A.O. Adekunle (eds) *Issues in the 1999 Constitution* (NIALS, Lagos: 2000) pp.110-111.

208 §270 CFRN 1999.

209 §255 *ibid.*

210 *Viz.*, both the Federal High Court and the High Court of the FCT, Abuja.

211 §§237 & 240, CFRN 1999.

212 §§230 & 232, CFRN 1999.

investment laws, the policies behind of these laws are determined by the executive and legislature. The next section summarises the political and policy framework which determines the content of investment and tax incentive laws.

3.1.3. Political Framework for Tax Incentives & Economic Policy

Tax incentive policy and administration are usually matters of federal legislative and executive competence as most trade and corporate taxes fall under the Exclusive Legislative List.[213] Special public bodies cooperate with the Federal and States' Boards of Inland Revenue to grant, administer and monitor the implementation of tax incentives. Certain federal bodies and key public officials are also involved in economic policy formulation as regards tax incentives and other selective interventions. Much of this policy-making is executed under the supervision of the President, Vice-President and certain Ministers (particularly the current Finance Minister, **Dr. Shamsuddeen Usman**).

The National Economic Council (hereafter: NEC)[214] is empowered to advise the President on economic matters particularly those involving coordination among the various tiers of government. NEC members include the Vice-President, the 36 State Governors and the Governor of the Central Bank of Nigeria (hereafter: CBN).[215] Budgeting, fiscal policy and the promotion of sustained economic growth and development have frequently featured on NEC's agenda. Similarly, the National Economic Intelligence Committee analyses, monitors and assesses fiscal measures.[216] This Committee's remit also extends to tax evasion, auditing inappropriate returns and improving revenue collection. Other bodies, like the Nigerian Investment Promotion Commission (hereafter: NIPC) deal directly with investment policy implementation. NIPC serves as a 'one-stop-shop' for foreign and local investors by facilitating

213 §4(1)-(5) and Part I of the Second Schedule, CFRN 1999.
214 §153 of, and ¶¶18 & 19 of the Third Schedule to, CFRN 1999.
215 ¶18 of the Third Schedule, CFRN 1999.
216 §4, *National Economic Intelligence Committee Act, No. 17 of 1994*.

business registration, licensing, permits and tax incentives.[217] NIPC also coordinates its activities with government agencies to improve the investment environment and serves as the secretariat for the Presidential Advisory Council on Investment.[218]

While general principles of Nigerian investment policy may have remained largely consistent over the years, the particular policies and administrative arrangements adopted by any incumbent regime have changed with the frequent change of regimes. The resultant high turnover of ministers and policymakers has led to a bewildering matrix of abandoned and unimplemented policies.[219] Policy inconsistency is one of the many issues borne out of historical reasons that have significantly impacted the use of fiscal incentives and other investment promotion measures to improve the Nigerian investment climate.

Various economic strategies have been adopted over the years ranging from the primary commodities export-oriented policies of the post-colonial era, import-substitution in the 1960s, to the proliferation of public enterprises[220] and indigenisation of industries[221] in the 1970s. Some, like the 1986-1992 Structural Adjustment Programme (SAP) were developed with the advice and support of the IMF and other multilateral agencies.[222] Under SAP, market-oriented reforms were introduced to deregulate prices and improve terms of trade.[223] Other policies have involved wide-spread consultation with the domestic private

217 NIPC succeeded the Industrial Development Coordination Committee (IDCC) (as a result the repeal of the *IDCC Act No. 36 of 1989*.and the *Nigerian Enterprise Promotion Act No. 54 of 1989*): see *NIPC Act No. 16 of 1995*.

218 NIPC Annual Report 2004, p.49.

219 E.I. Kachikwu, *Nigerian Foreign Investment Law and Policy* (Mikzek Law Publications Ltd, Lagos: 1988) p.365.

220 Under the 2nd National Development Plan of 1970-1974.

221 See Kachikwu, *Nigerian Foreign Investment Law and Policy*, *op cit*, chapters 6 and 7; Tom Forrest, *The Advance of African Capital*, J.D.Y. Peel and David Parkin (eds) (Edinburgh University Press, Edinburgh: 1994), pp.36-38.

222 G.F. Moser, S. Rogers and R. van Til with R. Kibuka and I. Lukonga 'Nigeria: Experience with Structural Adjustment,' IMF Occasional Paper (IMF, Washington D.C.:1997).

223 S. Thomas and S. Canagarajah 'Poverty in a Wealthy Economy: the Case of Nigeria,' IMF Working Paper WP/02/114 (IMF, Washington D.C.: 2002) p.8.

sector. In 1996, Abacha's administration embarked on the Vision 2010 project to develop an economic and political blueprint for Nigerian progress towards the year 2010.[224] The Vision 2010 Committee developed an elaborate public-private sector partnership to implement political and economic programmes intended to transform Nigeria into a leading and democratic African economy.[225] However, the lack of continuity and commitment in implementing proposed democratic and economic reforms rendered the project largely redundant[226].[227]

Recent economic policy under the Obasanjo administration has been largely spearheaded by **NEEDS**[228] which the Yar'Adua administration has adopted and is implementing within a strategic **7-Point Agenda** framework.[229] NEEDS is a poverty reduction strategy paper (hereafter: PRSP) targeted at coordinating the efforts of the federal, state and local governments[230] with other stakeholders[231] to realise Nigeria's economic potential by reorienting national values, reducing

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224 See the Vision 2010 website <http://www.vision2010.org/> accessed 18 March 2006.

225 By: encouraging private sector-led development; diversifying from energy and enhancing the real sector; encouraging microenterprises to reduce poverty; increasing indigenous participation in the energy sector; promoting a competitive, modern financial system; introducing reforms on investment law, privatisation, population control; and creating a macroeconomic environment that encourages private investment. Of note was the intention to use Export Processing Zones and other fiscal incentives to support microenterprises and to improve revenues by enhanced tax collection and reduced tax evasion.

226 Ironically, the Vision 2010 Report's view that '... Nigeria must institute a stable and democratic system of governance that guarantees economic prosperity within a culture of the rule of law' was the Achilles' heel as its failure was ultimately precipitated by the insincerity of the Abacha's commitment to return Nigeria to civilian rule: Vision 2010 Report: Charting the Future Development of Nigeria, *Political, Socio-Cultural and Economic Direction*, Section I: Introduction.

227 Some of the ideas of the Vision 2010 project have been adopted and refined in the NEEDS programme: see *Meeting Everyone's Needs: National Economic Empowerment and Development Strategy*, (2004: Nigerian National Planning Commission, Abuja), (hereafter 'the NEEDS Report') Chapter 11: Implementation and Financing, p.viii.

228 NEEDS is being executed by the National Planning Commission and National Council on Development Planning: see the National Planning Commission's website at <http://www.nigerianeconomy.com> accessed 15.03.06.

229 Nigerian Budget Speech 2008, by President U.M. Yar'Adua, pp.2,3 <http://www.fmf.gov.ng/portal/index.php> accessed 08.12.07.

230 By the complementary SEEDS and LEEDS programmes: NEEDS Report, Chapter 11: Implementation and Financing, pp.103-110.

231 Notably the private sector, civil society, foreign investors and multilateral development agencies.

poverty, creating wealth and generating employment. Key strategies target the emergence of the private sector[232] as the engine for economic growth in key economic sectors.[233] NEEDS proposes **fiscal initiatives** such as increasing revenue collection by expanding the tax base and reforming tax administration;[234] the reduction of multiple taxation; regional integration into the ECOWAS common tariff zone; and the **selective[235] use of tax incentives to promote private sector investment.**[236]

Some of NEEDS' fiscal reforms are to be effected through FIRS' Tax Reform Bills[237] some of which have been passed into law by the National Assembly. This legislative initiative is complemented on the executive front by a tax policy reform by the Budget Office of the Federation, the Federal Ministry of Finance and FIRS, as encapsulated in the draft National Tax Policy. The draft National Tax Policy sets out guiding principles which will inform future fiscal policy. The origins, scope and merits of this policy initiative are considered in Chapter 7. The next section will catalogue and examine Nigerian tax incentives in the context of existing tax law and regulations with a view to defining the role these fiscal interventions have played in promoting sustainable economic development.

232 NEEDS Report, Chapter 2: The Development Challenges Facing Nigeria, p.9.
233 *Viz.*, agriculture, manufacturing, services, energy and solid minerals development.
234 NEEDS Report, Chapter 5: Creating a Competitive Private Sector, pp.55-58.
235 Selective as the government has indicated the intention to 'rationalise' the number and scope of existing incentive schemes: NEEDS Report, Chapter 5: Creating a Competitive Private Sector, Box 5.1: Institutional and Administrative Reform to Reduce the Cost of Doing Business, p.56.
236 NEEDS Report, Overview, pp.xvii-xx.
237 Nine Draft Bills on Tax Reforms (FIRS, Abuja: 2005).

3.2. SECTORAL TAX INCENTIVES

3.2.0. INTRODUCTION

Some of the earliest efforts in post-Independence Nigeria to use tax incentives to stimulate investment were made under the *Aid to Pioneer Industries Ordinance of 1952* which provided for 2-5year tax holidays. This was succeeded by further tax holidays,[238] accelerated tax write-downs and capital allowances,[239] import duty refunds,[240] protective tariffs[241] and assurances. The current cocktail of tax incentives has evolved from these early efforts to use using selective fiscal interventions. The following sections provide a sectoral exposition of these incentives as a prequel to the critique of their use in the Nigerian economy.

3.2.1. AGRICULTURE & FOOD SECURITY

3.2.1.1. Introduction

Agriculture has traditionally been the backbone of the Nigerian economy, employing the largest percentage of the workforce and contributing the greatest share of national GDP.[242] Forrest notes that the pre-Independence economy was dominated by small farmers and family production units linked by traditional communal, kinship and lineage ties.[243] Traditional subsistence farming was pursued along with the cultivation of cash-crops such as ground-nut, cocoa, rubber and oil palm. Crop exports were promoted by the development of transportation linkages under British colonial rule. Large-scale mechanised farming became more prominent in the 1970s promoted by influential indigenous entrepreneurs. However, monetary devaluation and other economic policies pursued in the 1980s adversely affected agricultural competitiveness.[244] Increased public intervention in the economy during the

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238 See *Industrial Development (Income Tax Relief) Act of 1958*.
239 See *Income Tax (Amendment) Act of 1958* (later *Companies Income Tax Act of 1961*).
240 See *Industrial Development (Import Duties Relief) Act of 1957* and *Drawback (Customs) Regulations of 1959*.
241 See *Customs Duties (Dumped and Subsidised Goods) Ordinance of 1958*.
242 NEEDS Report, Chapter 6: Sectoral Strategies, p.68.
243 Forrest, *The Advance of African Capital*, *op cit*, pp.18-20.
244 *Ibid*, p.243.

1970s created perverse incentives which contributed to the decline of agriculture in the 1980s/1990s.[245]

NEEDS seeks to reverse this decline.[246] Proposed strategies include encouraging private sector investment; reducing dependency on imports by enhancing food security; emphasising value-added, export-oriented activities; providing rural credit and financial assistance; improving transportation and distribution networks; and promoting relevant research activities. NEEDS proposes to generate ₦3billion in annual revenues by focusing on the export of cassava[247] and other cash-crops. Curiously, NEEDS is largely silent on the role (if any) of tax and non-tax incentives for agriculture. However, Nigerian tax legislation features various fiscal incentives specifically targeted at agriculture.

3.2.1.2. **Incentives for Research on Tropical Agriculture**

The International Institute of Tropical Agriculture (hereafter: IITA) is an international research institution located in Ibadan, Oyo State and established under the *International Institute of Tropical Agriculture Act No. 32 of 1967* (hereafter: IITA Act). It is funded by the Ford and Rockefeller Foundations, international organisations,[248] foreign donor countries[249] and the Nigerian government.[250] Its objects include serving as a high-quality international research organisation; cooperating with research centres to increase food

245 The decline of tradable sectors such as agriculture during this period has been attributed to the waste and inefficiency associated with an expanding public sector in manufacturing and services: X. Sala-i-Martin and A. Subramanian *Addressing The Natural Resource Curse: An Illustration From Nigeria*, IMF Working Paper WP/03/139 (2003: IMF, Washington D.C.) pp.15-17.

246 NEEDS Report, Chapter 6: Sectoral Strategies, pp.68-70.

247 Cassava recently has attracted much attention from foreign (Chinese) investors and public functionaries given its untapped export potentials: see 'Chinese Firms Jostle for Nigerian Cassava', *This Day* [newspaper article by Etim Imisim], 7th March, 2006 <http://www.thisdayonline.com/nview.php?id=42549> accessed 09.03.06.

248 Including the Consultative Group on International Agricultural Research, the World Bank, Food and Agricultural Organisation of the UN and the International Fund for Agricultural Development.

249 Including the UK (via DFID), Denmark, Canada and the EU.

250 IITA Annual Report 2003 (Financial Information) <http://www.iita.org/annrpt/annrpt03.htm> accessed 25.04.06; IITA Annual Report 2005 (Financial Information), pp.59-61 <http://www.iita.org/cms/articlefiles/279-ar2005.pdf> accessed 08.04.06.

production, quality and distribution; distributing improved plant materials to other research centres; providing resources for scholars and scientists; and organising local, regional and international forums to discuss and disseminate learning in tropical agriculture.[251] Recent projects include research into germplasm and agrobiodiversity for tropical crops, and improving biological control options to promote food security, poverty alleviation and enhance lives in Sub-Saharan Africa.

From inception, the IITA has been an autonomous, non-profit and tax-free international organisation. IITA enjoys certain tax incentives which include **customs duties exemptions** for imported equipment, supplies, machinery, and furnishings.[252] IITA's income benefits from indefinite **corporate income tax exemptions**. A significant proportion of IITA's staff and management are expatriates reflecting its international character. The income of expatriate IITA staff,[253] and the scholarships, grants and in-service training allowances accruing to IITA researchers are equally **exempt from personal income tax.**[254] Given the international, educational, charitable and donor-sponsored character of the IITA, it is unsurprising that these extensive customs and income tax incentives apply to encourage such important research.

3.2.1.3. Pioneer Incentives for Agro-allied Industries

A wide variety of agricultural activities enjoy **'pioneer status'** under the *Industrial Development (Income Tax Relief) Act No. 22 of 1971* (hereafter: ID/ITR Act 1971) which confers **tax holidays** on eligible activities and entities.[255] The criteria for qualifying 'pioneer' industries are that: there is a dearth of investment in the particular industry; the scale of operation is not suitable for national economic requirements; there are favourable prospects for further development; or indeed, the promotion of the industry or its product is in the

251 §2, and the Schedule to the IITA Act.
252 §11 IITA Act.
253 Provided derived from the IITA or from sources outside of Nigeria.
254 §12 IITA Act.
255 As other sectors (e.g. manufacturing, mining and infrastructure) enjoy this 'pioneer status', the discussions of the Act's provisions here are applicable to those sectors.

public interest.[256] Indigenous and foreign investors may apply for pioneer status for their companies or products.[257] The screening procedure is discretionary: the President[258] may grant pioneer status (with or without conditions) or reject the application.[259] In practice NIPC is responsible for the day-to-day administration of the pioneer incentives scheme.

The statutory pioneer **tax holiday** lasts for 3 years initially, renewable for up to 2 additional years upon the satisfactory performance of the company. Performance is measured against certain criteria set out in the ID/ITR Act 1971.[260] Other criteria used in practice by NIPC include the levels of export potential, value added, local employment generated and amount of profits ploughed back into operations.[261] **Profits** from approved pioneer activities are **tax-exempt** during the tax holiday although profits accruing from non-pioneer products and activities remain taxable.[262] **Capital allowances and losses** may be carried forward to the post-pioneer period providing continuity into normal corporate tax rules.[263] Eligible agro-allied businesses include the cultivation and processing of crops, vegetables and fruits; the manufacturing of cocoa products; oilseeds processing; dairy production; cattle ranching; the manufacture of animal foodstuff; deep sea trawling; and coastal/inland lake fishing.[264] In 2004, 4 agro-allied firms (engaged in dairy farming, crop cultivation, sorghum processing and fishing) were awarded pioneer tax

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256 §1(1), ID/ITR Act 1971.

257 According to the Act, the capital threshold is higher for foreign investors ₦150,000 as opposed to ₦50,000 for indigenous investors: §1(2) ID/ITR Act 1971. However, in practice, a threshold of ₦10million is required by way of minimum paid-up share capital for both indigenous and foreign owned companies.

258 Originally the Federal Executive Council/National Council of Ministers exercised this discretion: §1(1) ID/ITR Act 1971.

259 §2(6) ID/ITR Act 1971. Failure to fulfil the conditions (e.g. as to qualifying expenditure or estimates of proposed products) may result in cancellation of the pioneer status: §§7 & 8 ID/ITR Act 1971.

260 E.g. the rate of expansion, standard of efficiency and development of the pioneer company; the utilisation of local raw materials, training and development of Nigerian personnel; and the location and relative importance of the industry: §10, ID/ITR Act 1971.

261 Investors' Guide to Nigeria Brochure (Nigerian Investment Promotion Commission), Chapter 7: General Incentives, p.55.

262 §12, ID/ITR Act 1971.

263 §§11 and 14, ID/ITR Act 1971.

incentives.[265] However, the pioneer tax holiday operates in exclusion to **rural investment allowances** on capital expenditure (hereafter: capex) expended in areas with poor infrastructural facilities.[266]

3.2.1.4. Direct and Indirect Tax Incentives for Agriculture

Under CITA 1979, corporate taxes are payable on the trading or business profits of any company accruing in, derived from, brought into or received in Nigeria unless otherwise provided.[267] Companies income tax is charged on taxable profits,[268] with such chargeable profits being arrived at after the companies' accounting profits are adjusted for tax purposes by deducting interest and other allowable expenses. However, numerous corporate tax incentives promote investment in agriculture and agro-allied industries.

Withholding tax exemptions on interest are granted to lenders providing long-term loans to companies engaged in agricultural trade or business. Qualifying agro-allied businesses include management of rubber, oil palm, cocoa, coffee and tea plantations; cultivation of cereals, fruits and cash-crops; animal husbandry and fishing.[269] Normal rules restricting **loss carry-forward periods** to four years before their expiry are relaxed so the income tax shields from losses attributable to the first year of operations or trade **operate indefinitely**.[270] Farms, plantations, fisheries and other facilities established in rural, underdeveloped and inaccessible locations enjoy **rural investment allowances** depending on the type of infrastructure required. The lack of telecommunication facilities attracts a 5% allowance while green-field investments in areas without any facilities at all are rewarded with a 100% tax

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264 Schedule to the ID/ITR Act 1971.
265 Table 7.2.3.1: Pioneer Status granted to Companies in 2004, NIPC Annual Report 2004, pp.56-59.
266 §19 ID/ITR Act 1971; §§34 and 40(12) CITA 1979.
267 §8(1)(a) CITA 1979.
268 §29 CITA 1979.
269 Qualifying loans must provide for moratoriums of at least 18 months and low (base-rate) interest rates: §11(7) CITA 1979.
270 §31 CITA 1979.

allowance.[271] **Initial allowances** permit the **accelerated depreciation** of 95% of capex incurred for plantation activities, agricultural plant and plantation equipment.[272] The generous capital allowances regime continues with the **removal of the normal restriction**[273] on the quantum of capital allowances claimable in a particular year of assessment.[274] **VAT exemptions** are provided under the *Value Added Tax Act No. 102 of 1993* (hereafter: VATA 1993) for supplies of basic food items, fertilisers, locally produced agriculture and veterinary medicine, farming machinery and transportation equipment.[275]

While many of these agro-allied tax incentives have been in the statute books for decades, recent developments have increased investment in agriculture. In 2004, the Governor of Kwara State (Bukola Saraki) invited 15 displaced Zimbabwean farmers to establish large-scale farms for the cultivation of maize, soya beans and other cash crops. The initiative has proved extremely successful in a relatively short period of time, expanding beyond the pioneer farms in the Tsonga area and compelling other states and indeed, the federal government to mimic Kwara State's agricultural revolution.[276] Nevertheless, it is unlikely that agriculture will reclaim its former position as the foremost economic sector since the ascendency of the energy sector.

271 Capital allowance rates include those for capex on tarred feeder roads (15%); water supplies (30%) and electricity (50%): §34 CITA 1979.

272 The first year allowance rate is 95% and the residual 5% remains in the accounts to be used in computing balancing allowances or charges on disposal of the asset or entity: ¶¶1&6 of; and Tables I & II to the Second Schedule, CITA 1979.

273 Under normal income tax rules, companies may not claim allowances in excess of 66 2/3% of assessable profits.

274 ¶24(7) of the Second Schedule, CITA 1979. However, capital allowances appear to be capped at 95% of the associated capex in the first year claimed: ¶6 of the Second Schedule, CITA 1979.

275 Including tractors, ploughs and other agricultural implements: First Schedule, VATA 1993.

276 'Obasanjo, Governors Meet on Zimbabwe Farmers, *This Day* [newspaper report by Tunde Sanni], 15th December, 2005 <http://www.thisdayonline.com/nview.php?id=35817> and the Kwara Project website available at <http://www.kwaraproject.com/index.php?option=com_frontpage&Itemid=1> both accessed 16.12.05.

3.2.2. ENERGY

3.2.2.0. Introduction

Energy remains Nigeria's dominant economic sector despite the efforts of successive Nigerian administrations to encourage diversification.[277] Most state participation in the sector has been through the national oil company, the Nigerian National Petroleum Corporation (hereafter: NNPC) [278] and its subsidiaries with the Department of Petroleum Resources (hereafter: DPR)[279] performing regulatory functions.

Nigeria finds it relatively easy to impose and collect taxes on high value energy rents to meet much of its public expenditure requirements without recourse to the taxation of other economic sectors. Consequently, Nigeria is often classified as a rentier state as energy-related receipts (profits, taxes, rents and royalties) constitute the single largest source of public revenues.[280]

(See Figures 3.1 & 3.2 below.)[281]

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277 The exploitation of crude oil dominates the energy sector, with Nigeria's enormous gas reserves (estimated at three times the crude oil reserves) being largely untapped for decades: Yinka Omorogbe 'The Legal Regime for Petroleum Production and Development in Nigeria', in C.O. Okonkwo (ed) *Contemporary Issues in Nigerian Law: Essays in Honour of Judge Bola Ajibola*, (Toma Micro Publishers Ltd: Lagos: 1992), pp.201-202.

278 NNPC was established on April 1, 1977 by the merger of the erstwhile Nigerian National Oil Corporation and the Federal Ministry of Mines and Power: §5 *Nigerian National Petroleum Corporation Act, No. 33 of 1977.*

279 DPR traditionally operates under the oversight of the Federal Ministry of Petroleum Resources. Under the Obasanjo regime, this ministry was subsumed under the Presidency's bureaucracy. Further changes have been made by the Yar'Adua administration to the structure of the energy sector.

280 Evan S. Lieberman, *Race and Regionalism in the Politics of Taxation in Brazil and South Africa*, (Cambridge: Cambridge University Press, 2003), p.58; Axel Harneit-Sievers, 'Reforming the Rentier State: Some Thoughts on NEEDS,' *op cit*, pp.xi-xix.

281 Source: 2008-2010 Medium Term Fiscal Strategy Paper: Executive Brief to the Federal Executive Council, Federal Ministry of Finance/Budget Office of the Federation (Abuja FCT: August 2007), slides 25&18.

Figure 3.1: Sources of 2008 Federal Budget Revenue (₦billions)

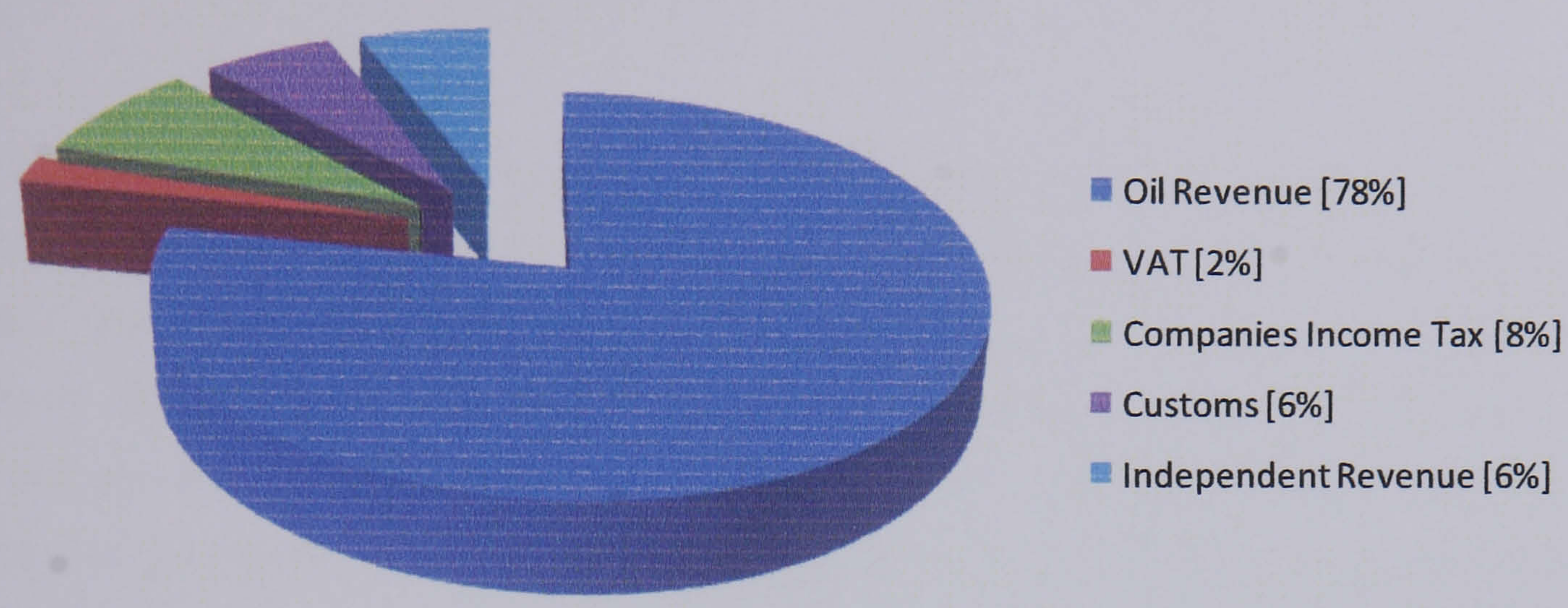

Figure 3.2: 2008 FAAC Oil Revenue at Benchmark Price (₦billions)

Recent energy sector policy under NEEDS emphasises private sector participation through privatisation and liberalisation, improving key sub-sectors (e.g. petrochemicals and downstream activities), increasing indigenous participation through 'marginal fields' development and 'local content' [282] regulations, and the promotion of forward and backward integration. A review and codification of the legal regime and specifically, energy sector tax

282 Recent economic policies seek to achieve local content levels of 45% by 2006 and 70% by 2010: see NNPC website (webpage Nigerian Content Development in the Oil and Gas Sector) <http://www.nnpcgroup.com/faq.htm> accessed 18.04.06.

incentives is a key policy and may see the expansion or targeting of incentives to achieve some of these objectives in line with the ongoing tax reform project.[283]

The legal regime for the exploitation of petroleum resources is hinged on two laws: the *Petroleum Act, Legal Notice 69 of 1969* (hereafter: Petroleum Act 1969) and the *Petroleum (Drilling and Production) Regulations of 1969* (hereafter: Petroleum Regulations). Petroleum Act 1969 vests ownership of petroleum resources in the federal government and defines the legal regime for the exploitation of these resources through oil exploration licences, prospecting licences and mining leases.[284] Application fees, rents and royalties are required to be paid for these licenses and leases.[285] All these taxes, fees, rents and charges are required to be paid by companies engaged in petroleum operations under the relevant statutory provisions.

While Nigerian companies are normally liable to companies' income taxation, the profits of companies engaged petroleum operations are exempt.[286] These revenues, however, are charged to tax by the provisions of the *Petroleum Profits Tax Act, No. 15 of 1959* (hereafter: PPTA 1959) insofar as they accrue to companies engaged in petroleum operations.[287] Tax liability under PPTA 1959 is charged on aggregate earnings under the following heads: the proceeds of all chargeable oil sold by the company in that period; the value of all chargeable

283 NEEDS Report, Chapter 6: Sectoral Strategies, pp.76-77.

284 Numerous contractual arrangements exist for the exploitation of petroleum resources, including concessions, joint ventures, production sharing contracts and service contracts: Yinka Omorogbe 'The Legal Regime for Petroleum Production and Development in Nigeria', *op cit*, pp.190-199.

285 §2 of and the First Schedule to the Petroleum Act 1969. The relevant rates are fixed pursuant to the Petroleum Regulations.

286 Formerly, §19(1)(h) CITA 1979 provided that: '...the profits of any company engaged in petroleum operations, within the meaning of section 2 of the Petroleum Profits Tax Act, shall, in so far as those profits are derived from such operations and liable to tax imposed by that Act, be exempt from the tax imposed under this Act;...'. Under the codified version of CITA 1979 (Cap. C21, Vol. 3, LFN 2004) this provision has been deleted. However, this is unlikely to detract from the practice that excludes petroleum operations companies from the CITA 1979 tax regime.

287 §2(c) PPTA 1959 defines 'petroleum operations'; this definition has been significantly extended by the Supreme Court's decision in *Shell Petroleum Development Co. (Nig.) Ltd. v. FBIR [1996] 8 NWLR (pt. 466) 256.*

oil disposed of by the company in that period; the value of all chargeable natural gas[288] disposed in the relevant period; and all income of the company of that period incidental to and arising from any one or more of its petroleum operations.[289] However, income from the transportation by sea of chargeable oil is excluded from taxation.[290]

Companies engaged in petroleum operations pay tax at the unusually high **85%**[291] nominal[292] rate assessed on their chargeable profits,[293] derived after certain allowable deductions in respect of capital allowances[294] have been made against their assessable profits. These assessable profits[295] are derived after deductions for loss relief[296] have been made as against the adjusted profits. The adjusted profits[297] of the companies are the profits for the relevant accounting period[298] after certain allowable deductions[299] have been made and certain disallowable deductions have been corrected, by adding them back to the period's profits.[300] Petroleum companies pay royalties and are liable to tax under the *Education Tax Act, No. 7 of 1993* (hereafter: ETA 1993) assessed at 2% of the companies' assessable profit.[301] However, dividends derived from petroleum operations companies are exempt from withholding tax in the hands

288 Basically, such quantities of natural gas delivered pursuant to the terms of any gas sales contract by the taxpayer company to the national oil company, the NNPC, exclusive of gas taken by the Federal Government under Article 34, of the First Schedule to Petroleum Act 1969: §2(c) PPTA 1959.

289 §9(1) PPTA 1959.

290 With a corresponding, symmetrical treatment for any losses: §14 PPTA 1959.

291 §21(1) PPTA 1959.

292 However, where the relevant company has yet to commence commercial disposal of chargeable oil and accordingly, is yet to fully amortise certain un-recovered capital expenditure, the nominal rate is reduced to **67.75%**: §21(2) PPTA 1959. In practice, the effective rate is lower due to generous rules for losses and capital allowances.

293 Defined in §9(5) PPTA 1959.

294 §20 and the Second Schedule to PPTA 1959.

295 Defined in §9(4) PPTA 1959.

296 §16 PPTA 1959.

297 §9(3) PPTA 1959.

298 Defined in §2 PPTA 1959 in relation to the period in that particular year, during which the concerned company was operating and engaged in petroleum operations.

299 §10 PPTA 1959.

300 §13 PPTA 1959.

301 §1 ETA 1993.

of recipients.[302] The next section examines the relevant tax incentives available to relieve taxation in the energy sector.

3.2.2.1. Energy Sector Tax Incentives

3.2.2.1.1. Enhanced Deductions: Expenses, Capex & Loss Relief

A wider variety of **expenditures are tax deductible** under PPTA 1959 than is the case under CITA 1979. These allowable deductions[303] comprise rents,[304] royalties[305] and charges for customs and excise duties whether on specific capital expenditure or of a more general character; certain interest expenses; expenditure on repairs, renewals, and alterations of premises, plant, machinery, and other implements employed in petroleum operations; certain costs treated as expensed revenue items; and approved pension/provident fund contributions.

Certain expenditures are disallowed.[306] The pro-indigenous enterprises 'local content' policy manifests itself with certain customs on imports being disallowed.[307] The provisions generally enshrine a clear distinction between revenue items (deductible) and capital items (non-deductible). Consequently, any capital withdrawn from the undertakings of petroleum companies is disallowed as are capital improvements to facilities as opposed to mere repairs, renewals and alterations. Other disallowed expenditure include rent incurred for non-petroleum operations, local or foreign income tax charges,[308] deductions for accounting depreciation and certain non-approved payments.

302 §60 PPTA 1959.
303 §10 PPTA 1959.
304 These rents are in consideration of the rights granted investors under oil prospecting licences and mining leases. Productive rents (associated with leases and licences) and non-productive rents are deductible.
305 In respect of sales of natural gas, crude oil and casing-head petroleum spirit.
306 §13(1) PPTA 1959.
307 Particularly where locally-manufactured substitutes of equivalent quality and affordability are available.
308 However, stamp duties and education tax charged under the ETA 1993 are deductible under §10(l) PPTA 1959.

PPTA 1959 provides certain incentives[309] to promote the utilisation of both **associated gas**[310] and **non-associated gas.**[311] These include **deductions** for operational expenditure (hereafter: opex) which would otherwise be classified as capex. Outlays incurred to separate crude oil and gas into usable products are deductible as expenses against crude oil income.[312] Similar deductions are allowed against income from natural gas operations assessed to tax under CITA 1979.

Finally, **tax deductions for losses** under PPTA 1959 are significantly more generous than those under the general corporate tax regime. Generally, under CITA 1979, losses may be carried forward and relieved against taxable profits for up to 4 years of assessment before they expire.[313] However, under PPTA 1959 the **carry forward loss relief period is indefinite**: losses may relieved indefinitely in computing assessable profits, limited only by the availability of adjusted profits against which these can be set off. Companies may also exploit rules permitting them to elect to defer losses to be utilised in succeeding accounting periods.[314] This produces a useful incentive for long-term capital intensive projects with the long gestation periods typical in petroleum operations. The next section reviews the PPTA 1959 regime for capital allowances.[315]

3.2.2.1.2. Investment Allowances: PPTA 1959 Capital Allowances

Petroleum operations invariably require vast amounts of capex usually payable in foreign currencies to obtain the technological, engineering and other inputs required to successfully exploit energy resources. Consequently, PPTA 1959 provides generous **capital allowances** to reflect the economic depreciation of

309 §§11 & 12 PPTA 1959.
310 Or casinghead gas: this is natural gas produced with crude oil from the same reservoir or oil well.
311 Natural gas produced from a reservoir that does not contain significant quantities of crude oil.
312 §11(1)(a);(2)(c) and (d), PPTA 1959.
313 However, for agro-allied businesses, first-year losses (only) may be carried forward indefinitely and relieved against future profits: §31 CITA 1979.
314 §16 PPTA 1959.
315 §21 PPTA 1959.

such capex.[316] Outlays must fall under the following categories: qualifying plant,[317] pipelines and storage,[318] and building and drilling[319] expenditure. Two concurrent capital allowances are provided for. The first is accelerated depreciation provided by **annual allowances** at a rate of 20% per annum on qualifying capex, effectively writing off acquisition costs within 5 years. The second, the **petroleum investment allowance**, is an additional capital allowance granted on a graduated basis reflecting the location of capital equipment. As facilities located offshore are expensive to install and operate, the petroleum investment allowance provides additional allowances of up to 20% of capex for facilities and operations located on the continental shelf and in territorial waters exceeding depths of 200metres.[320] Where such equipment is acquired for utilisation in down-stream petroleum operations, it is also exempt from VAT.[321]

As is the case with any capital allowances, only profitable firms benefit from annual and petroleum investment allowances. This would ordinarily undermine the relevance of such incentives for the energy sector as capital-intensive petroleum operations typically have long investment horizons and may involve a series of incremental investment outlays with positive net present values only showing up years or even decades after final investment decisions are made. Happily, the law generously permits any **unused capital allowances to be carried forward** into subsequent years of assessment and set off against future assessable profits in computing chargeable income.[322] There is no discrimination against existing investors: all that is required is to establish that the new or incremental investment falls within the eligible categories of qualifying capital expenditure. There are additional incentives which permit

316 §20 of and the Second Schedule to, PPTA 1959.
317 Comprising capex on plant, machinery and fixtures facilities.
318 Comprising buildings, structures and other housing facilities.
319 This category includes expenditure on the acquisition of mining and exploration rights, searching and winning deposits and other ancillary outlays.
320 Lower allowances of 15%, 10% and 5% (respectively) are provided on the capital expenditure costs for facilities/operations located in territorial waters of depths of up to 200metres, 100metres and those located onshore.
321 First Schedule to VATA 1993.
322 Rollover provisions are found in §20(5) PPTA 1959.

opex on equipment required to deliver associated gas in usable forms or between pre-designated custody transfer points[323] to be treated as capex entitled to annual and petroleum investment allowances.[324] However, there are some limitations to the amount of capital allowances that may be claimed in a particular year.[325]

Capital allowances for gas projects are also provided for in other statutes. Sometimes capital allowances are coupled with some right of election being granted to eligible companies, as seen in the next section which examines energy incentives available under the CITA 1979.

3.2.2.1.3. Mix & Match: CITA 1979 Accelerated Depreciation & Tax Holidays

Special incentives are provided for gas utilisation projects, particularly in the downstream sector.[326] Eligible companies must choose between a tax holiday package and a capital allowance package as these options are mutually exclusive. The **tax holiday option** would benefit projects with short gestation periods which would be profitable in early years. It involves an initial 3-year tax-free period commencing on due ministerial certification of production and is renewable for 2 further years.[327] Upon the expiry of the tax holiday, the investor is entitled to a first-year **accelerated capital allowance** of 90% of investment in plant and machinery in addition to a 15% **investment allowance**

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323 Nigerian Accounting Standard Board: Statement of Accounting Standard 17 (SAS 17): Accounting in the Petroleum Industry: Downstream Activities.

324 §11(1)(b) PPTA 1959.

325 Eligible companies must claim the lower of (a) the aggregate amount of annual and petroleum investment allowances computed in the ordinary way, and (b) a sum equivalent to 85% of the assessable profits (profits after loss relief and deductible expenses) less 170% of the sum of petroleum investment allowances for that year; subject, however, to the overriding stipulation that at least 15% of the tax payable were the annual and petroleum investment allowances not granted should be paid: §20, PPTA 1959.

326 Eligible projects include the commercial marketing and distribution of natural gas (through gas transmission and distribution pipelines subject to no royalties and petroleum profits tax), and gas utilisation in power plants, LNG and gas to liquid projects, petrochemicals and fertiliser plants: §39 CITA 1979.

327 This is a discretionary extension contingent upon the 'satisfactory performance of the business'; however, the criteria for determining this is unclear.

which does not affect the assets' tax written value.[328] Finally, the relevant (post-holiday) rate of tax is the **reduced tax rate** of 30% under the CITA 1979 and not PPTA 1959's 85%.

The alternative **capital allowance option** is less generous and involves a one-off, first year 35% **investment allowance** which does not affect the computation of the relevant asset's tax written down value. Whichever option is elected, eligible companies may enjoy further incentives of **withholding tax exemptions** on dividends[329] and interest[330] payments. Under the *Deep Offshore and Inland Basin Production Sharing Contracts Act No. 9 of 1999* (hereafter: Deep Offshore/PSC Act 1999)[331] an **investment tax allowance** of 50% on the costs of qualifying capital expenditure incurred under eligible Production Sharing Contracts is deductible from taxable income.[332] The tax regime for Production Sharing Contracts also features reduced corporate tax rates as reviewed below.

3.2.2.1.4. Reduced Corporate Income Tax Rates: Production Sharing Contracts' Incentives

Production Sharing Contracts (hereafter: PSCs) are contractual arrangements for the exploitation of natural resources between a contractor and a host country whereby the contractor bears all of the exploration risk and incurs development costs in return for a significant portion of production revenues once commercial quantities of the resource are discovered. Ownership of the relevant acreage or oil field remains with the host country or its national oil company. The contractor assumes the risk of discovery and recoups its costs

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[328] This stands at 10% of the cost at the end of the first year, being the residue of cost after the 90% annual allowance has been deducted. This amount is retained in the accounting records till the asset is disposed of or business discontinued and the sum used to calculate the relevant balancing charge or allowance. The investment allowance rate was 5% prior to 1998.

[329] Provided the initial investment was financed by foreign exchange or imported equipment was involved equivalent to at least 30% of the company's share capital.

[330] Provided due ministerial consent was obtained for the relevant loan.

[331] As amended by the *Deep Offshore and Inland Basin Production Sharing Contracts (Amendment) Act No. 26 of 1999.*

[332] For Production Sharing Contracts entered into after the 1st of July, 1998. A similar **investment tax credit** is provided for PSCs concluded prior to this cut-off date: §4 Deep Offshore/PSC Act 1999.

only when crude oil is discovered and commercially exploited. The contractor's development costs, operating expenses and any taxes or royalties are payable from actual production. The residue of production revenue is split between the host country and the contractor on a sliding scale basis, often with the former obtaining a larger share when production is low and vice-versa to reward successful, risk-seeking contractors.

Consequently, PSCs are suitable where the host country is unwilling or unable to bear the financial burden and operating risks of exploration and development, and can find a suitable contractor to bear these expenses and risks in return for a significant portion of ultimate revenues. Numerous 30-year term [333] PSCs have been granted in Nigeria to (foreign-owned) [334] contractors since they were first introduced in 1972 with NNPC acting as the counterparty. A factor behind the growth in PSCs has been the inability of NNPC to consistently fund cash calls to defray shared expenditure under the terms of joint ventures with energy multinationals. Exploration, development and operating costs are typically recoverable from a percentage of crude oil production. Crude oil production is allocated to the parties on the basis of royalties, costs and corporate tax due by them.[335] These production allocations are deducted before the residue of profit oil is shared. Royalties are charged on a graduated basis with rates ranging from nought to 17% depending on the location of the petroleum operations.[336]

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333 10 years for exploration under oil prospecting licences and 20 years under oil mining leases.

334 E.g. Statoil, Ashland, Abacan, Esso, Agip, Shell, Elf, Mobil, Chevron, Conoco-Philips, and Allied Energy: see the Nigerian Investment Promotion Commission's website [webpage: Oil and Gas: Main Industry Policies] <http://www.nipc-nigeria.org/psc.htm> accessed 18.04.06.

335 §§8-12, Deep Offshore/PSC Act 1999.

336 For instance, onshore operations (and those in waters within depths of 200meters) may be charged at 16.67%; those in waters of depths exceeding 1001 meters are exempt of taxation, reflecting the increased difficulty of recovery of petroleum at such depths: §5, Deep Offshore/PSC Act 1999. See also the Nigerian Investment Promotion Commission's 'Oil and Gas: Main Industry Policies' <http://www.nipc-nigeria.org/psc.htm> accessed on 18.04.06.

Tax incentives by way of **reduced corporate tax rates** have been awarded to numerous Nigerian PSCs. Profits from energy sector PSCs should be normally liable to tax at the PPTA 1959 rate of 85%. However, the terms of Nigerian PSCs have traditionally provided for a **reduced tax rate of 50%**. This contractual regime of reduced tax rates was granted statutory backing by the provisions of the Deep Offshore/PSC Act.[337] While this rate is significantly higher than the typical corporate tax rate of 30%, the 35% rate differential as against the 85% PPTA 1959 rate is a substantial incentive, providing ammunition for critics who complain that some PSCs are unduly favourable to contractors.[338] Of particular concern is the manner in which a significant proportion of produced oil is allocated as 'tax oil' to defray private investors' petroleum profits tax liability, effectively meeting tax obligations out of shared gross production and not the net profits derived by the private investor.[339]

Another criticism is the contractual nature of the PSC reduced tax rate regime, which is quite typical of the manner in which Nigerian tax incentives in the energy are often implemented. While the use of informal agreements which effectively supersede statutory provisions has often been criticised[340] the practice persists. This is not surprising given the ease at which fiscal agreements between the federal executive authorities and private firms may be concluded often circumventing the lengthy process of passing enabling enactments through the National Assembly.

The next section considers generous tax incentives provided by the Memoranda of Understanding between the federal government and energy operators which

337 §3 Deep Offshore/PSC Act 1999; Yinka Omorogbe, *Oil and Gas Law in Nigeria*, (Malthouse Press Ltd, Lagos: 2003), pp.49-52.

338 Specifically referring to the first PSC concluded with Ashland Oil Company in 1973: *ibid*, p.49.

339 *Ibid*, p.50. Ostensibly, the high recovery ceilings of production oil against which tax and other expenses can be set off are to compensate the contractor concern for the large risks borne under the PSC: Yinka Omorogbe, 'Fiscal Regimes', (paper presented at the National Extractive Industries Transparency Initiative [NEITI] Civil Society Capacity Building Workshop at the Presidential Hotel, Port Harcourt, Rivers State on 28.07.05), p.8.

340 *Ibid*, p.10.

constitute a contractual and legally binding regime and also operate outside regular tax statutes.

3.2.2.1.5. **Incentive Cocktails: Memoranda of Understanding**[341]

The first Memorandum of Understanding (hereafter: MOU)[342] was the result of negotiations between public sector institutions (including the NNPC, and the Ministries of Petroleum and Finance) and NNPC's joint venture partners seeking to protect profit margins eroded by the oil glut and economic recession of the early 1980s. MOUs provide incentives to encourage exploration and production by energy operators. Private joint venture contractors are encouraged to lift crude oil allocations due to the NNPC which the latter is unable to appropriate.

Various fiscal measures are utilised to achieve these ends. For instance, a **capital investment relief** stimulates increased investment in upstream exploration and development operations. A **reserve additional bonus** also operates as a **tax credit** to encourage efforts to increase proven reserves. Early contractual provisions guaranteed a profit margin of US$2 per barrel of crude oil produced. Joint venture partners bear corresponding obligations to commit to specified levels of exploration, development and production with failure to meet these targets resulting in penalties and ultimately revocation of the special incentives regime. The basic MOU provisions have been frequently amended[343] with recent versions providing a two-tier profit margin based on the energy companies' net investment per unit barrel of production.[344] Other fiscal incentives include a **reduced tax rate** of 35% to compensate for high operating costs, a **tax credit** against ultimate petroleum profits tax liability equivalent to the differential between the aggregate of royalties and petroleum

341 *Ibid*, pp.9-10; Omorogbe, *Oil and Gas Law in Nigeria*, *op cit*, pp.77-78; Omorogbe, 'The Legal Regime for Petroleum Production and Development in Nigeria', *op cit*, pp.193-194.

342 The first MOU came into effect on 1 January 1986.

343 In 1986, in 1991, January and July of 2000, and 2006.

344 Essentially, a new pricing formula introduced a higher guaranteed profit margin of US$2.70 which applies only where the barrel unit costs exceed US$2; otherwise a lower profit margin of US$2.50 applies.

profits taxes, and a specially calculated revised government take. However, recent policy statements indicate the federal government's desire to eliminate the MOU arrangement which is perceived as excessively generous given the present high prices of petroleum commodities.[345]

The MOU arrangement illustrates how collective bargaining by foreign investors has guaranteed a favourable fiscal regime. Tax incentive measures often are negotiated in special 'packages' particularly where a significant investment is proposed by foreign investors who often possess a stronger bargaining position than the host country government.[346] In Nigeria, 'packages' of financial, fiscal and other incentives to promote significant investments by private investors and multilateral aid agencies have often attracted their own enabling statute. Perhaps no other investment project has received as extensive incentives and guarantee support as the Nigerian Liquefied Natural Gas project considered next.

3.2.2.1.6. **Negotiated Incentive 'Packages': the Nigerian Liquefied Natural Gas project**

Since 1908 when energy exploitation first commenced, the local environment has been degraded by the adverse effects of petroleum development including oil spills, deforestation, soil erosion, leaching and gas flaring. Gas flaring has had particularly malignant effects on the environment particularly in the resource-rich Niger Delta. The statistics underscore the extent of the pollution: in 1998, 21 billion cubic meters of associated gas[347] were flared in Nigeria contributing 38% of OPEC's flared output in that year.[348] As Nigeria's

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345 Yakubu Lawal, 'Govt cancels incentives for oil firms,' *Nigerian Guardian* (Lagos 04.02.08) <http://www.guardiannewsngr.com/news/article02//indexn3_html?pdate=04020> accessed 04.02.08.

346 Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, pp.98-99.

347 Associated gas exists along side crude oil deposits. If the oil is extracted in the absence of adequate facilities (gas markets or infrastructure) to exploit this associated gas, such gas may be ignited and flared, or vented un-ignited, into the atmosphere.

348 Recent estimates indicate that as much as 2.5 billion cubic feet of associated gas is flared daily (a rise to 32 billion cubic meters per annum), amounting to 80% of

gas reserves exceed her considerable crude oil endowments, this practice is not only harmful to the environment but also quite wasteful in terms of potential revenues forgone.

Efforts to encourage gas utilisation by prohibiting gas flaring and imposing financial penalties have been largely unsuccessful due to the underlying economics. The utilisation of both associated and non-associated gas is extremely expensive in terms the level of infrastructure required. Rational energy operators would be inclined to opt for the less expensive alternative: flaring gas, paying fines and concentrating on exploiting more accessible and profitable crude oil reserves.[349] The absence of vibrant domestic gas markets and the presence of significant barriers to entry to international ones impose additional constraints.[350] Global initiatives[351] to reduce gas flaring have been complemented in Nigeria by market[352] and fiscal interventions. A unique, negotiated tax incentives 'package' was also provided for the Nigeria Liquefied Natural Gas project.

Nigeria LNG Ltd (hereafter: NLNG)[353] was incorporated in 1989 as a joint venture private company between NNPC,[354] Shell Gas B.V., Total LNG Nigeria Ltd., and ENI International (N.A.) NV, with the objects of exporting liquefied natural gas to exploit Nigeria's gas reserves.[355] Extensive environmental impact

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associated gas reserves utilised per annum: http://www.nigerialng.com/NLNGnew/faq/default.htm#When accessed 24.03.05.

349 Omorogbe notes the ineffectiveness legal efforts to curb gas flaring: deadlines were shifted repeatedly (from 1 January 1984 to 2008); exemptions permitted; and penalties grossly inadequate: Yinka Omorogbe, 'Law and Investor Protection in the Nigerian Natural Gas Industry', Vol.14, No.2 Journal of Energy and National Resources Law (JERL) pp.181-182.

350 *Ibid*, pp.180-181.

351 E.g. the World Bank's Global Gas Flaring Reduction Partnership of 2002.

352 Notably the Oso I and II condensate projects undertaken by ExxonMobil.

353 Omorogbe, 'Law and Investor Protection in the Nigerian Natural Gas Industry', *op cit*; see the NLNG website at <http://www.nlng.com/NLNGnew/default> accessed 24.03.05.

354 With a 49% equity stake; as such, the participation of foreign multinationals in NLNG is at 51%, effectively constituting a controlling stake.

355 Essentially, the project involved the construction and operation of an LNG plant based in Finima, Bonny Island (located in the Nigerian Niger Delta). The Base

studies were concluded under local environmental protection legislation[356] before the commencement of operations. Financing for the project has generated record-breaking inflows of FDI into Nigeria, with shareholders' equity investments of US$3.6billion necessary to finance the Base Project[357] and the Expansion project.[358] The NLNGPlus Expansion Project[359] was partly financed by a record-setting syndicated loan of US$1.060billion. In addition, thousands[360] of technical jobs were created during the construction of the various trains. Given the prospects of successive trains and the commitment of the company to increasing local content in its supply chains and operations, this trend is bound to continue.

The *Nigeria LNG (Fiscal Incentives, Guarantees and Assurances) Act No. 39 of 1990* (hereafter: NLNG/FIGA Act)[361] grants an inimitable form of **pioneer status** to NLNG, extending the typical **corporate tax holiday period** from the norm of 5 years to a maximum of 10 years.[362] Post-holiday tax liability is at the **reduced corporate income tax rate** of 30%[363] and not the significantly higher PPTA 1959 rate of 85%.[364] Finance-related tax incentives include **interest tax deductions** on any loans to NLNG,[365] and **full exemption from withholding taxes**[366] on interest,[367] 'ring-fenced'[368] dividends and payments for services[369]

Project comprised of Trains 1 and 2 completed on August 12, 1999 and February 27, 2000 respectively.

356 *Environmental Impact Assessment Act No. 86 of 1992* and the *Federal Environmental Protection Agency (Amendment) Act No. 59 of 1992*.

357 Trains 1 and 2.

358 Train 3.

359 Comprised of Trains 4 and 5.

360 Over 18,000 technical jobs were created in constructing the Base Project.

361 As amended by the *Nigeria LNG (Fiscal Incentives, Guarantees and Assurances) Act No. 113 of 1993*.

362 Subject to certain sales thresholds, which if exceeded, limit the extent of the pioneer period: §2 NLNG/FIGA Act.

363 §40 CITA 1979.

364 §3 NLNG/FIGA Act.

365 §5 *ibid*. This is a significant incentive as normally, interest on loans to petroleum operators is only tax-deductible in limited circumstances (e.g. where the rate is closely linked to LIBOR): §§11&1, PPTA 1959).

366 Normally charged at 10%: §§78-82 CITA 1979; *Company Income Tax (Rates, etc of Tax Deducted at Source [Withholding Tax]) Regulations of 1997*.

367 Again, a significant incentive given the magnitude the debt finance borne by the NLNG project.

provided to NLNG by foreign firms. Related parties' **capital gains** on the transfers of shares in NLNG are similarly **tax exempt.**[370] Income from BGT Ltd (NLNG's wholly-owned shipping **subsidiary**) is tax exempt.[371] **Export duties** on exported gas products are waived; **import, customs and other tax exemptions** exist for a wide range of necessary imports of plant, machinery, goods and construction materials.[372] Normal benefits from **capital allowances** and **loss relief** are preserved beyond the end of the pioneer period[373] and general limitations as to the quantum of capital allowances claimable within a year of assessment do not apply.[374] However, it is unclear if these tax exemptions extend to recently introduced taxes such as VAT.[375]

In addition to these generous fiscal incentives, the NLNG/FIGA Act includes extensive guarantees, undertakings and assurances granted by the federal government to NLNG and its shareholders on matters ranging from free repatriation of funds, provision of land and infrastructure, employment of expatriate staff to compensation for expropriation.[376] As important as the NLNG project may be in terms of attracting FDI and generating revenues, it utilises mostly non-associated gas. Consequently, its positive impact on gas flaring is limited.[377] However, Nigerian tax law provides incentives for the utilisation of associated gas as noted in **§3.2.2.1.1** above. Further incentives

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368 Tax-exempt dividends are only paid out of pioneer period profits: §17 ID/ITR Act 1971.

369 For instances, supply and engineering services provided under extensive Engineering Procurement and Construction (EPC) contracts.

370 §6 NLNG/FIGA Act.

371 §6 NLNG/FIGA Act and §14 CITA 1979.

372 Provided that certain procedures are complied with: §7 NLNG/FIGA Act.

373 §1 NLNG/FIGA Act; §14 ID/ITR Act 1971.

374 Under normal corporate income tax rules, capital allowances are capped at 66 2/3% of assessable profits in any particular year of assessment: see §31 of and ¶24(7) of the Second Schedule to CITA 1979.

375 VATA 1993 was introduced before the commencement of the fiscal regime under the Second Schedule to the NLNG/FIGA Act.

376 Second Schedule of the NLNG/FIGA Act reads more like a boilerplate loan agreement than a typical Nigerian statute, prompting criticism from Omorogbe that the Federal Government is seeking to legislate for stability in the investment environment: Omorogbe, 'Law and Investor Protection in the Nigerian Natural Gas Industry', *op cit*, pp.188-191.

377 Omorogbe, 'Law and Investor Protection in the Nigerian Natural Gas Industry', *op cit*, p. 184.

are granted under the oil and gas export free zone legislation considered in the next section.

3.2.2.1.7. Incentives for Gas: Oil & Gas Export Free Zone (OGEFZ)

The *Oil and Gas Export Free Zone Act, No. 8 of 1996* (hereafter: OGEFZ Act 1996) establishes an Export Processing Zone (hereafter: EPZ) in the Onne/Ikpokiri area of Rivers State in the Nigerian Niger Delta. The provisions are almost ***in pari material*** to that of the *Nigerian Export Processing Zones Act, No. 63 of 1992* (hereafter: NEPZ Act 1992).[378] The few differences between the tax incentive regimes provided under the bespoke OGEFZ Act 1996 and the more general NEPZ Act 1992 include: the establishment of a separate and distinct Authority to administer this Oil and Gas EPZ;[379] the prominence of representatives of the Rivers State Government and Department for Petroleum Resources on the Authority's governing board;[380] and the possible role of the Authority established under OGEFZ Act 1996 taking over the management of EPZs engaged in the export of oil and gas located elsewhere in Nigeria established under the NEPZ Act 1992.[381]

Typical EPZ fiscal incentives relating to **exemption from customs duties, excise levies, rates and VAT** are granted.[382] Capital and consumer goods, raw materials, components and other intermediate materials may be imported into the EPZ **free from customs duties**. Activities permitted within the EPZ include assembly, manufacturing, processing, repackaging, storage, export and consumption of imported materials.[383] Retail trade of imported materials within the EPZ is prohibited unless special permission is obtained.[384] The EPZ is treated as separate from the Nigerian customs territory such that goods are

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[378] Discussed in greater detail below at §**3.2.5.2** of this Thesis.
[379] §§2-7, OGEFZ Act 1996.
[380] Evidently to represent the views of the State in which the EPZ is sited and the supervising government department.
[381] §5(2) OGEFZ Act 1996.
[382] Part I, First Schedule to VATA 1993.
[383] §§12 & 18 OGEFZ Act 1996.
[384] Curiously, those limiting sales in the domestic customs territory to a minimum of 25% of production. This seems to be a draftsman's error: §§14 & 18 OGEFZ Act 1996.

treated as imports from other countries and subject to the normal customs, licensing and VAT rules.[385] **Import tariff rebates** are also provided for products processed in the EPZ which are subsequently imported into the Nigerian customs territory.[386] These incentives are complemented by a **total exemption from federal taxes** (notably corporate income tax, petroleum profits tax, export duties, stamp duties, corporate capital gains taxes and withholding taxes), **state taxes** (including personal income taxes, business registration fees and individuals' capital gains taxes) and **taxes imposed by local government authorities**.[387]

Non-fiscal incentives include free remittance of capital, profits and dividends; a simplified import, export and licensing regime; rent-free land; the prohibition of strikes and industrial action; no restrictions on foreign ownership of firms; reduced restrictions on the employment of expatriates; and provisions to facilitate trade finance and securitisation.[388] While these incentives appear to be specifically targeted at attracting FDI,[389] other incentives are clearly directed at encouraging investments by indigenous entrepreneurs. This is illustrated by the fiscal incentive regime for marginal field operators.

3.2.2.1.8. Reduced Tax Rates: Marginal Fields Incentives for Indigenous Operators

Given the risky, capital-intensive nature of petroleum exploration, production and development, it is unsurprising that the sector is dominated by energy multinationals. Omorogbe commends the rise of indigenous companies despite the difficulties these entrepreneurs face in raising finance, arguing for financial incentives and assistance to promote their presence in this vital sector.[390] She argues for the use of policy interventions to create a supportive environment

385 §17 OGEFZ Act 1996.
386 ¶1 *Oil and Gas Export Free Zone (Special Import Provisions) Order 2003, S.I. No.2 of 2003.*
387 §8 OGEFZ Act 1996.
388 §§18 & §12(3)(b) OGEFZ Act 1996.
389 U.J. Osimiri, 'Stimulation of Investment in energy through Nigerian tax exemption laws' 2002 OPEC Review, March 2002 pp.46-60.
390 Yinka Omorogbe, *Indigenous Oil Companies and the Nigerian Petroleum Industry*, chapter 9, p.112-113.

within which indigenous companies could flourish.[391] One such policy has been the Marginal Fields Development Programme which is specifically targeted at developing indigenous exploration and production capacity in the upstream sector.

The 1996 amendments to the Petroleum Act 1969[392] set the stage, empowering the Head-of-State to compel energy multinationals which held oil mining leases to farm out marginal fields which had not been developed for over ten years due to: marginal economics, low ranking in the lessors' reserve portfolios, high gas and low oil reserves or the lack of proximity to existing projects and facilities.[393] In 1999, 119 fields were classified as marginal and efforts to develop these culminated in September 2001 with the successful award of concessions to 24 marginal fields[394] out of 200 available fields to 32 indigenous companies.[395] While some of the awardees have commenced some level of operations, commercial production of these fields has been delayed largely due to difficulties in raising necessary finance, obtaining appropriate technical support and security concerns in the Niger Delta.

Indigenous marginal fields' operators can take comfort from tax incentives. These mainly consist of a **reduced tax rate** of 65.75% of chargeable profits[396] for the first five years of operations, increasing to the normal PPTA 1959 rate of 85% in subsequent years.[397] However, discussions between this Researcher and marginal field operators indicate that Presidential approval has been obtained to reduce the prevailing rate to 55% throughout the life of the field's

391 *Ibid*, p.120.
392 By the *Petroleum (Amendment) Act No.23 of 1996.*
393 Guidelines for Farmout and Operations of Marginal Fields, [August 2001] (Abuja; Office of the Presidential Adviser on Petroleum and Energy, 2001) pp.7-8.
394 With estimated reserves at 300million barrels of crude.
395 NNPC website (webpage Nigerian Content Development in the Oil and Gas Sector) <http://www.nnpcgroup.com/potential.htm> accessed 24.04.06
396 §21 PPTA 1959.
397 Marginal Fields: Technical and Commercial Field Specific Bid Tender Submission Requirements [June 2002] (Lagos: Department of Petroleum Resources, 2002) p.8 <http://www.dprnigeria.com/margifldisumrqt.htm> accessed 02.05.06.

operations.[398] **Investment tax credits** vary from 10% to 15%, depending on the location of qualifying assets.[399] Graduated royalties are still paid to the FIRS and the original lease holder.

The energy sector is one of many sectors in which the ability to effectively harness financial and technical resources may determine success or failure. The foregoing discussion has reviewed tax incentives applicable to particular energy sub-sectors that are used to improve the investment environment. Energy sector fiscal incentives serve a variety of purposes including countering the unusually high tax rate applied on oil rents, compensating for the lack of physical infrastructure in most oil producing areas and recognising the immense financial resources required to exploit energy resources. The next section considers tax incentives granted to providers of credit and other financial services.

3.2.3. Financial Services

3.2.3.0. **Introduction**

Private-sector led economic growth is a central theme under NEEDS. Financial institutions fund such growth and serve as intermediaries between investors and enterprises requiring finance. Financial sector regulation is based on the *Central Bank Acts of 1991 & 2007*, the *Banks and Other Financial Institutions Act No. 25 of 1991* (hereafter: BOFIA 1991) the *Insurance Act No. 1 of 2003* and the *Investment and Securities Act No. 45 of 1999*. The Central Bank (hereafter: CBN) is vested with wide supervisory powers to regulate financial institutions in

398 Marginal fields' operators may apply directly to the Department of Petroleum Resources to benefit from the reduced 55% tax rate while the new regime queues for legislative approval to pass it formally into law. (This, of course, is yet another example of how often the regulatory reality is far removed from the law prescribed in statute books): Statement by Johnson Salako, CEO: Goland Petroleum Development Company, Lagos, Nigeria (personal communication 26-28 April, 2006).

399 *Viz.*, 10% for onshore investment; 15% for investment in water depths up to 100metres; 20% in waters 100metres deep and beyond: see Marginal Fields: Technical and Commercial Field Specific Bid Tender Submission Requirements [June 2002], *op cit*, p.8.

conjunction with the Nigerian Insurance Commission (hereafter: NAICOM)[400] and the Nigerian Deposit Insurance Corporation.[401] Financial institutions are usually required to be incorporated under the *Companies and Allied Matters Act No. 1 of 1990* (hereafter: CAMA 1990) and as such, are subject to normal corporate tax[402] on their taxable profits.[403]

Regrettably, Nigeria's capital markets have remained shallow relative to the size of the economy due to problems of under-capitalisation, mismanagement and poor corporate governance precipitating successive Nigerian banking crises between the 1950s[404] and the 1990s.[405] Banks were notorious both for their pursuit of short-term profits from arbitrage opportunities on currency markets and reluctance to lend to long-term, real sector projects. A World Bank/IMF survey of the private sector in Nigeria (hereafter: Nigeria PSA Report)[406] ranks access to finance as the second most-quoted challenge for private sector manufacturing firms owing to the unavailability of long-term finance, inadequate collateral or guarantees and prohibitively high interests rates. These high rates may incorporate a risk premium associated with business uncertainty, a weak contract enforcement/judicial system, unreliable financial data and the lack of a lengthy trading history.

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400 Established under Act No. 1 of 1997 (hereafter: NAICOM Act 1997).

401 §33-35, BOFIA 1991.

402 At 30%. However, there is an additional 'excess profits' tax imposed at 15% on the excess of normal profits over 'standard profits' (calculated by reference to the capital employed by the company) with a threshold of N6million. While this excess profits tax is applicable to all companies, it usually only affects banks and insurance companies that are required to maintain high capital levels (N25billion and N10billion respectively): §40 CITA 1979.

403 Special accounting and taxation rules apply *vis-à-vis* the calculation of accounting and taxable profits for banks and insurance companies: see generally Nigerian Accounting Standard Board: Statements of Accounting Standard 10 & 15, Accounting for Banks and Non-Bank Financial Institutions I & II.

404 Forrest, *The Advance of African Capital*, *op cit*, pp.35-36.

405 J.U. Ebhodaghe, 'Distress Management and Prevention Strategies for the Nigerian Banking System', in Peter N. Umoh (ed) *Safe and Sound Banking Practices in Nigeria: Selected Essays by John U. Ebhodaghe* (Page Publishers Services, Lagos: 1997), pp.27-30.

406 *Nigeria Private Sector Assessment: Technical Papers*, Regional Program on Enterprise Development, Africa Region, September 2002 (World Bank, Washington D.C.: 2002), pp.20-21;78-82 & Part 3.

CBN is currently implementing certain reforms of the financial sector in line with NEEDS and the Financial Systems Strategy (FSS) 2020.[407] Banks are being encouraged to provide microfinance facilities for small and medium-sized enterprises (hereafter: SMEs). As such, NEEDS seeks to remedy financial sector deficiencies by adopting a quartet of policy thrusts: deepening asset volumes and instrument diversity in the financial sector; reducing financial sector-funded public deficits; providing incentives for financial institutions to invest in the real sector; and, most controversially, reviewing the capitalisation of financial institutions. [408] The tax incentives that accompanied the capitalisation exercise are considered in the next section.

3.2.3.1. Tax Incentives for Banking & Insurance Consolidation

Shortly after Prof. Charles Soludo[409] was appointed as the Governor of the CBN in May 2004, the CBN introduced a policy of consolidation in the Nigerian banking sector[410] with far-reaching implications.[411] The principal policy thrust was mandatory increase in minimum capitalisation by way of shareholders' funds[412] for banks to ₦25billion[413] within an 18-months implementation horizon. The policy precipitated a wave of bank mergers reducing the number of banks from 89 to the eventual 25 banks compliant by

[407] Under FSS 2020, the CBN intends to reform the Nigerian financial system to become a leading global financial hub by 2020: Prof. Charles Soludo, 'Nigeria's Financial System Strategy 2020 Plan: "Our Dream"' Presentation at the FSS 2020 International Conference, Abuja, Nigerian on 18.06.07 <http://www.cenbank.org/fss/fsshome.asp> accessed 04.10.07.

[408] NEEDS Report, Chapter 6: Sectoral Strategies, pp.75-76.

[409] Soludo had previously served as the Chief Economic Adviser to the President and led the team that developed NEEDS.

[410] At the Nigerian Bankers' Committee meeting held on the 6th of July 2004 in Abuja, Nigeria.

[411] This Researcher has considered the conflicting views on the consolidation policy elsewhere. This section draws heavily from that article: see further Oyebode Oyetunde, 'Consolidation Reform of the Nigerian Banking Sector: The Perspectives of Angels and Trolls,' [2005] J.I.B.L.R. pp.280-285.

[412] Essentially accumulated reserves, equity and preference share capital unimpaired by losses and excluding accretions from asset revaluation.

[413] Approximately US$194.5million or £112.8million as at 30 December 1995 (see Rates Archive on CBN website: <http://www.cenbank.org/Rates/ExchangeArchives.asp> accessed 03.03.08. Previously, under the CBN's Monetary, Credit, Foreign Trade and Exchange Policy Guidelines existing banks were required to have shareholders funds of ₦1billion with new entrants into the banking sector required to achieve a ₦2billion threshold under the Central Bank Guidelines.

December 2005 who now may hold public sector funds and access foreign exchange allocation through official channels.[414]

A key element in the Central Bank's incentive packet for merging banks was the commitment to work with the relevant tax authorities to provide tax incentives.[415] Various tax incentives may be considered under applicable tax codes, including the companies' income tax, capital gains tax (under the *Capital Gains Tax Act No. 44 of 1967*, hereafter: CGTA 1967), value added tax,[416] and stamp duties regimes (under the *Stamp Duties Act No. 5 of 1939*, hereafter: SDA 1939). Nigerian tax law does not currently provide for group and consortium relief available in other jurisdictions to merging and reorganising related corporate entities in respect of trading losses, excess charges, or management expenses.[417] However, a limited tax advantage may be gained by way of reconstruction and merger relief.

Corporate tax rules allow companies to elect to which accounting reference dates to make up their accounts. In circumstances where taxable companies make up accounts to different dates, various rules apply granting the taxman, or the taxpayer, as the case may be, **rights of election**. Where an existing company changes its accounting reference date to coincide with its parent company,[418] the taxman has a right of election to charge tax on the higher of chargeable profits based on the old accounting date, and such profits based on the new accounting date.[419] In relation to prospective bank mergers, a target

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[414] CBN Governor's Speech, 'Consolidating the Nigerian Banking Industry to Meet the Development Challenges of the 21st Century, delivered on the 6th of July, 2004 at the Central Bank of Nigeria offices in Abuja, Nigeria <http://www.cenbank.org/documents/speeches.asp> accessed 01.02.05.

[415] Particularly as regards capital allowances, companies income tax and stamp duties: see ¶4.4 of the CBN's Guidelines and Incentives (published on 5 of August 2004 <http://www.cenbank.org/out/publications/bsd/2004/consolidation.pdf> accessed 01.02.05.

[416] Under VATA 1993.

[417] For a UK perspective see: David Southern & PricewaterhouseCoopers' Treasury Tax Team, *Taxation of Loan Relationships & Derivative Contracts* (8th edition, Tottel Publishing: 2007) pp.275-280.

[418] §336(2) CAMA 1990.

[419] §29(2) CITA 1979.

bank that is ceasing to operate[420] would suffer a similar tax disadvantage of being subject to the taxman's right of election as regards tax basis periods.[421] Should several banks form a consortium and consequently merge, the new bank, conversely, would enjoy the tax relief of exercising a right of election.[422] Consequently, the merging or target entities face the prospects of a large tax bill particularly if their recent profits have been high. However, by proper structuring of the transaction to met relevant conditions, the merging entities may be able to benefit from **merger and reconstruction relief**. In the main, the relevant provisions[423] disapply the right of election rules highlighted above[424] and preclude the incidence of balancing charges on the disposal of assets of the merging or target companies.[425]

Capital gains from disposals of taxable assets are liable to tax[426] on the realised or market value of the disposal[427] of chargeable assets. The relevant assets classes are quite wide and include both tangible assets like branch premises and intangibles like goodwill.[428] In related-party transactions, market values are substituted for the contract purchase consideration in computing tax liability.[429] Similarly, transactions deemed artificial or fictitious are disregarded.[430] The merging banks could face a significant tax charge given the large values of the consolidating undertakings. Here too, the taxman could give **merger relief** in respect of shares acquired as purchase consideration by shareholders of the target or merging banks in the acquiring or new bank.[431]

420 Being liquidated and whose undertakings are being transferred to the acquiring bank.
421 §29(4) CITA 1979. As such, the taxman exercises a right of election to select the higher of assessable profits thrown up by computing to on the preceding year basis and actual year basis.
422 §29(3) CITA 1979.
423 §29(9) *ibid.*
424 However, the taxpayer's right of election due to a change in accounting date remains: §29(9)(a) *ibid.*
425 However, no initial allowance relief may be enjoyed by the acquiring or new entity post-merger.
426 At 10%: §2 CGTA 1967.
427 §6-7; §23 *ibid.*
428 §3 *ibid.*
429 §7, 23-24 *ibid.*
430 §21 *ibid.*
431 Such shares being consideration for the disposal of shares and interests previously held by the target company's shareholders: §§32A & 31(1), *ibid.*

This relief is peculiar to share-for-share acquisitions and it is instructive to note that this was the Central Bank approved mode of consideration, except where payments to minority shareholders are involved.[432]

Value added tax is imposed, charged and payable on specified taxable goods and services. A taxable person[433] is required to pay input tax to a supplier, on purchases of taxable goods and services and is obliged, when supplying taxable goods and services to distributors, agents, clients or consumers to collect output tax on these supplies.[434] Input VAT on service and administration expenses, and expenses incurred in connection with capital assets are generally required to be expensed or capitalised, respectively, in the taxpayer's financial statements.[435] Consequently, VAT on the professional fees of legal advisers, financial consultants, reporting accountants and auditors, stockbrokers and other professionals would be expensed in the profit and loss account of the merging institutions.[436] In some jurisdictions, it may be possible to recover input VAT attributable to professional fees relating to such essential services as financial and legal advice, due diligence exercises, contract negotiation and transaction structuring and coordination activities, particularly in share for share takeovers. Regrettably, Nigerian VAT law is not as sophisticated. However, in line with the CBN's declared intention to facilitate the consolidation activities and provide necessary professional services and technical assistance, it would have been worth the while of banking stakeholders to press for similar relief to be provided by legislation for this purpose. It is unclear if similar relief was sought and obtained in any of the merger transactions.

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432 ¶7.10 of the CBN's Guidelines and Incentives.
433 §42, VATA 1993.
434 §§10 & 11 *ibid.*
435 §13A *ibid.*
436 Such fees would qualify as charges arising from the consumption of services rendered and thus liable to VAT: Taofeeq Abdulrazaq, 'Consolidation Brings Tax Changes to Banking Industry,' reprinted from Tax Notes International Dec. 19, 2005, p.1039.

Stamp duties are charged at flat or *ad valorem* rates on relevant instruments, which are executed in Nigeria or relate to property or things to be done in Nigeria.[437] The consequences of not stamping such instruments go to the admissibility of such documents in civil proceedings and for other purposes.[438] Stamp duties are vital costs in mergers, given the numerous documents required to be executed in respect of the transferred properties and undertakings of consolidating banks. In any case, **merger relief** is available by amalgamating companies where transactions are structured as business acquisitions or the acquisition of shares, under certain provisions.[439]

On the whole, the consolidation exercise proved to be relatively successful[440] increasing the sector's share of the Nigerian Stock Exchange's total market capitalisation by 26% to 50%, attracting US$500million in FDI, and improving liquidity, credit and depositor confidence.[441] 25 successful banks emerged although only 76 banks of the original 89 banks were actually involved in mergers.[442] These 25 surviving banks have since been rewarded by the CBN with greater investment opportunities including the privilege of being global custodians of the nation's considerable foreign reserves.

However, despite the CBN's declared intention to work with the relevant authorities to provide special tax incentives for merging banks,[443] it appears in practice that the CBN relied only on the limited tax incentives currently

437 §3 SDA 1939.

438 §22(4) SDA 1939. However, the documents may be admissible in criminal proceedings and in other limited circumstances.

439 §104 *ibid.*

440 Despite valid criticism from certain commentators: Tunde I. Ogowewo and Chibuike Uche, '(Mis)Using Bank Share Capital as a Regulatory Tool to Force Bank Consolidations in Nigeria', Journal of African Law, 50 (2006) pp.161-186.

441 CBN Press Release of 12.01.06 'Soludo to Receive Global, African Banker of the Year Award' available at <http://www.cenbank.org/OUT/PUBLICATIONS/PRESSRELEASE/GOV/2006/PR%2012A-1-06.PDF>.

442 The successful 25 banks accounted for 93.5% of the industry's deposit share; the unsuccessful 13 banks representing 6.5% faced subsequent liquidation: see CBN Press Release of 03.01.06 '25 Banks Meet December 31st Deadline' <http://www.cenbank.org/OUT/PUBLICATIONS/PRESSRELEASE/GOV/2006/PDF%203-1-06%20PR.PDF> accessed 01.03.06.

443 ¶4.4 of the CBN's Guidelines and Incentives.

provided by Nigerian law.[444] Consequently, many merging banks utilised tax planning strategies similar to those outlined above.[445] The apparent lack of coordination between the CBN and the 'relevant authorities' was underscored by a Public Notice in which the FIRS reminded merging entities of their need to seek its prior approval before any merger, takeover, transfer or restructuring of any business could be fully consummated.[446] Oddly enough, FIRS' Public Notice was issued on 6 February 2006, well after the CBN had concluded the consolidation exercise and published the list of the 25 successful banks on 3 January 2006. Even more curious was the concluding statement to the effect that the FIRS would not entertain requests for approval of mergers unless it was informed before the commencement of the exercise.

Unsurprisingly, the FIRS Public Notice has attracted the censure of leading tax practitioners who criticise FIRS for creating further uncertainty in relation to the concluded consolidation exercise.[447] These developments raise concerns about the FIRS' administrative and technical capacity to implement complex policies and coordinate effectively with other key public agencies. However, FIRS' Tax Audit Department and Large Taxpayers Unit evidently has previous experience with merging corporations and has conducted routine post-merger audits on successfully merged banks.

Insurance companies have also been required to increase their capital base.[448] The new policy applies from September 1, 2005 for existing firms and February

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444 It is unclear if this policy was due to a conscious policy not to extend the scope of available tax incentives further.

445 Recent discussions with leading legal advisers to merging banks in Lagos revealed that while tax planning often was approved on a transactional basis, options that this Researcher had previously identified were adopted: Oyebode Oyetunde, 'Consolidation Reform of the Nigerian Banking Sector: The Perspectives of Angels and Trolls', *op cit*, pp.283-284.

446 FIRS required merging banks to give it notice of their intended mergers and to attach merger plans, three-years audited accounts and letters of guarantee by successor entities to discharge the tax liabilities of their merging predecessors. FIRS alluded to an understanding with the CBN that mergers would be approved in principle, pending the satisfactory completion of tax audits by the FIRS.

447 Taofeeq Abdulrazaq, 'New tax notice on bank consolidation in Nigeria creates uncertainty', (Deloitte Touche Tomatsu, Lagos: 2006).

448 Essentially paid-up equity capital and any reserves unimpaired by losses.

28, 2007 for new firms. Life insurance companies are required to increase their capital base from ₦150million to ₦2billion; for general insurance firms and reinsurers, the capital base has increased to ₦3billion and ₦10billion from ₦120million and ₦350million respectively. [449] The insurance regulator – NAICOM – (in conjunction with the FIRS) proposed to provide tax incentives to facilitate the consolidation of firms in the insurance industry. It is unclear what the exact incentives comprise and whether these were identical to those provided to merging banks. The views expressed above in relation to merging banks are applicable to consolidating insurance companies as well and consequently will not be repeated.

Finally, certain **pension** reforms have been implemented under the *Pension Reform Act No. 2 of 2004* (hereafter: PRA 2004). PRA 2004 exempts retirement benefits from tax[450] and provides tax deductibility for employee contributions toward eligible contributory pension schemes. [451] The banking, insurance and pensions reforms are some of the key economic policies the current administration has implemented to improve the performance of the financial sector and capital markets. The next section examines reform proposals for using tax incentives to improve the bond market which has been relatively shallow, illiquid and undeveloped.

3.2.3.2. Bond Market Reform & Tax Incentives

Recent economic policy has favoured bond market reform with several committees set up in recent years to propose progressive strategies. In 2000, a Securities and Exchange Commission Committee Report[452] suggested numerous

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[449] §9 *Insurance Act, No. 1 of 2003*; 'Guidelines for the Insurance Sector: Reform and Consolidation', issued on September 30, 2005 by the Nigerian Insurance Commission (NAICOM), Abuja, Nigeria; <http://www.naicomonline.org/currentaffairs/Issues.htm> accessed 14.06.06.

[450] §7 PRA 2004.

[451] §10 *ibid.*

[452] The Committee was set up on June 15 2000 by the Director-General of the Securities and Exchange Commission (SEC) to examine constraints to capital market growth and suggest solutions for reform: Bond Market Committee Report (hereafter: SEC Committee Report) <www.secngr.org/pdffiles/BondMarketOutlineofReport.pdf> accessed 14.06.06.

reforms targeted at reforming perceived deficiencies with the Nigerian bond market.[453] Suggested **tax incentive reforms** included providing tax relief for bond issues; [454] exempting bond yields from withholding tax; [455] making debentures eligible for capital gains exemptions,[456] tax roll-over relief and providing withholding tax exemptions for interest on local loans;[457] reducing stamp duties[458] and generally providing tax incentives to promote long-term capital formation and wider participation in the capital markets.[459]

As noted above, one of the key policy objectives under NEEDS is to deepen asset volumes and instrument diversity in the financial sector. Some changes have been made such as reintroducing government development stocks, settling debts due to local contractors by the issue of government bonds, improving capital market infrastructure and permitting investments in 3-year bonds by financial institutions to meet regulatory reserves and liquidity requirements.[460] In February 2006, a Bond Market Steering Committee was established to help design, harmonise and implement strategies to promote capital and bond

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453 The Committee noted the following problems: high illiquidity due to the absence of a viable secondary market; relatively few government issues leading a negative yield curve and the lack of a benchmark rate to help price private issues; and the effect of military rule and the absence of rule of law on the markets: SEC Committee Report at pp.13-15.

454 It is unclear from the SEC Committee Report if this relates to tax deductibility of issue costs: *op cit*, at p.7.

455 It was argued that this measure was necessary to eliminate tax arbitrage between bonds (whose yields were subjected to withholding tax) and money market instruments (bankers acceptances, treasury bills, letter of credit etc on which no withholding tax was payable): *ibid*, p.20.

456 This measure was to be targeted at bond issues with long-term tenors: *ibid*, p.21.

457 Roll-over relief applies under CGTA 1967 and postpones tax on the proceeds of disposals of eligible capital assets provided these proceeds are 'rolled-over' or used to acquire similar capital assets. Tax reliefs for foreign sources loans are examined below; the proposals were to replicate these incentives for locally sourced loans: *ibid*, p.7.

458 By replacing ad valorem rates with capped flat rates: *ibid*, p.20.

459 *Ibid*, p.7.

460 Charles Soludo 'Special Remarks by the Governor of the Central Bank of Nigeria,' at the 2005 Nigerian Bond Market Technical Roundtable held at Le Meridien Hotel, Abuja on Tuesday, June 28, 2005 at <http://www.cenbank.org/documents/speeches.asp> accessed 14.06.06.

markets.[461] Unfortunately, NEEDS is silent on the use of tax incentives to achieve these ends. There are certain instances where **interest income** accruing to holders of federal government bonds is **exempt from withholding taxes**.[462] Similarly, **capital gains** derived from government securities, treasury bonds, saving certificates and premium bonds are **exempt from tax**.[463] However, it remains to be seen if any tax incentives (such as those recommended by the SEC Committee Report) are deemed sufficiently desirable enough to be adopted as suitable reform strategies.

Another area in which greater clarity as to the role (if any) of fiscal incentives is in developing the leasing sector (considered next).

3.2.3.3. **Leasing, Hire Purchase & Tax Incentives**

Nigeria's hire purchase and leasing sectors are relatively underdeveloped, dominated by commercial and merchant banks, and service mainly the energy and manufacturing sectors. However, finance leases are often provided for communication, administration and transportation equipment.[464] The Nigeria PSA Report argues that – with improved leasing laws, more professionals, greater access to pension funds and enhanced fiscal advantages from tax law reforms – leasing can become a viable alternative means of finance, particularly for SMEs unable to secure medium and long term facilities from commercial lenders.[465]

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461 Linda Elueme and Eromosele Abiodun 'Bond Market Steering Committee Inaugurated', *This Day* article (27th February, 2006) <http://www.thisdayonline.com/nview.php?id=41868> accessed 03.03.06.

462 E.g., see ¶7 *Local Loans (First Federal Government of Nigeria Bonds 2003) (Amendment) Directions 2004, Statutory Instrument No. 3 of 2004* cf. *Companies Income Tax [Rates, Etc., of Tax Deducted at Source (Withholding Tax)] Regulations Statutory Instrument No.10 of 1997*.

463 §30 CGTA 1967.

464 Operating leases are usually provided for smaller, less expensive equipment.

465 Nigeria PSA Report, pp.89-91.

Unfortunately, the precise tax treatment of hire-purchase, finance and operating lease arrangements under Nigerian law is not particularly clear.[466] Relevant Nigerian accounting standards require **finance leases** to be so classified if the lease term covers 80% or more of the asset's useful life; the net present value of the lease at inception is equivalent to or greater than its fair value; or the purchase option at the end of the lease is likely to be exercised by the lessee. All other leases are classified as **operating leases**.[467] The distinction is crucial as it affects the lessee's decision whether to borrow (for finance leases) or buy (for operating leases) instead of taking out a lease. Certain accounting consequences also follow the classification. Fiscal benefits seem to be restricted to the use of capital allowances and tax-deductible interest to shield business profits.

A **finance lease** is economically equivalent to a debt-financed asset acquisition.[468] However, Nigerian tax law follows the legal form and treats the arrangement as the hiring of goods for profit. The lease rentals are tax-deductible for the lessee and resultant tax shields reduce the after-tax leasing costs. As the lessee does not 'own' the asset, the lessee loses both (a) the depreciation tax shields from capital allowances and possibly (b) interest tax shields from tax-deductible interest payments.[469] These demerits are mitigated if the lessee's taxable income is insufficient to absorb available capital allowances or deduct all interest charges. If the lessor is in a superior financial position and enjoys both allowances and tax-deductible interest, some benefit could be passed on to the lessee in lower lease rentals. Brealey and Myers note that value to both the lessor and lessee would be optimal when the lessor's tax bracket is significantly higher than that of the lessee;[470] accelerated capital allowances are available to realise depreciation tax shields early in the asset's

466 The principle income tax statutes (CITA 1979 and PPTA 1959) lack specific rules on these issues. What is clear is that an entity may claim capital allowances on assets 'owned' by it and tax deductions for interest charges it incurs.

467 Nigerian Accounting Standard Board: Statement of Accounting Standard 11 (SAS 11): Accounting for Leases.

468 The lessee invariably acquires the asset and the fixed rental obligations are only cancellable upon payment of compensation for the lessor's finance costs.

469 I.e. if the lessee had borrowed to acquire the asset.

life; lease rentals are concentrated at the end of an extended lease period; and interest rates are relatively high to maximise the present value of the tax deferral.[471]

In **operating leases**, the lessor bears the acquisition risks and adds a premium to rentals to compensate for this. The tax advantages of capital allowances and tax-deductible interest are enjoyed by the lessor. However, as the lessor may be able to manage the pool of assets more efficiently, it may pass on some financial savings through lower lease rentals. Lessees also benefit from the option to cancel the lease and acquire immediate use of assets in return for a deferred financial liability. [472] Conversely, the hirer in **hire purchase agreements** is treated for tax purposes as the owner of the asset and is allowed to claim associated capital allowances. However, the quantum of such capital allowances is limited to the sum of the initial deposit plus instalments paid during a fiscal year. Capitalised instalments must exclude the imbedded interest element (which is tax deductible).

A perusal of Nigerian tax statutes does not indicate any additional tax advantages beyond those highlighted above. However, greater clarity in the tax treatment of these alternative arrangements may increase their accessibility to taxpayers. The next section examines tax incentives to encourage financial institutions' investment in the real sector.

3.2.3.4. Incentives for Foreign Financed Projects

Nigeria operates a classical system of taxation[473] and applies a combination of **source-basis rules** (for corporate tax) and **residence-basis rules** (for income tax under PITA 1993 to the incomes of foreign non-resident individuals and

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470 E.g. where the lessee benefits from reduced tax rates or other incentives.

471 R.A. Brealey and S.C. Myers *The Principles of Corporate Finance* (7th International Edition, McGraw-Hill, New York: 2003), chapter 26.

472 This may be attractive to small lessees who lack sufficient financial resources to buy assets outright.

473 Although some relief against economic double taxation is provided by provisions governing franked investment income and set-off rules for withholding taxes on dividend income.

corporate entities. Generally, indigenous individuals and Nigerian-based entities are taxed on their worldwide income while foreign individuals and firms are liable to tax on income derivable from commercial activities in Nigeria. However, where certain income is deemed to have been derived from Nigeria (in the case of non-resident corporate entities)[474] or to have accrued to individuals deemed to be resident in Nigeria (in the case of foreign individuals)[475] then such income is taxable.

For individuals, taxable income comprises income derived from sources within Nigeria or offshore,[476] and extends not only to dividends, interest or discount[477] but also to any other profit, gain or payment. [478] For foreign corporate investors, income from direct and portfolio investment typically takes the form of profit or capital repatriations, interest, rents, dividends or royalties. Similarly, the local subsidiaries of foreign concerns may be required to pay management fees, intellectual property royalties, technical service charges, management fees and patent fees for services and assistance provided by parent or associated companies. All these payments are subject to local withholding taxes at rates ranging from 5% to 10%.[479] However, for foreign recipients of these payments, the withholding tax charged is the final tax.[480]

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474 Certain deeming provisions provide a quartet of tests to determine derivation; these tests establish tax liability where circumstances indicate that a 'fixed base', authorised agency, single contracts for certain services or associated/subsidiary company relationship scenarios exist: §13(2) CITA 1979.

475 Rules for residence for tax purposes under 1st Schedule, PITA 1993 determine where in Nigeria the individual is resident or deemed to be resident in a year of assessment for the purpose of determining the relevant tax authority. Generally, a non-national must be resident for 183 days in a 12-month period or otherwise fall within the tax rules and have income liable to tax under the PITA 1993 before being resident for income tax purposes: §§2&108, PITA 1993; Ayua, *Nigerian Tax Law*, *op cit*, p.63; Ipaye, 'Overview of the Tax Environment: Issues and Challenges', in *CITN Nigerian Tax Guide & Statutes*, *op cit*, p.5.

476 §3(1) PITA 1993.

477 §3(3)(d) *ibid.*

478 §3(3)(f) *ibid.*

479 §§78-82, CITA 1979; *Companies Income Tax [Rates Etc. of Tax Deducted at Source (Withholding Tax)] Regulations S.I. No. 10 of 1997.*

480 §§78-80, CITA 1979.

Nigerian tax law provides certain incentives to encourage foreign direct and portfolio investment. There are **exemptions from withholding tax** for dividends from unit trusts; interest on deposit accounts of foreign non-resident companies and interest on foreign domiciliary accounts[481] accruing after 1 January, 1990.[482] Profits, dividends, interest, rent and royalties received in or routed through Nigeria through government approved channels[483] from operations of associated foreign companies or business operations would equally be tax exempt unless deemed to be derived from Nigeria.[484]

CITA 1979 provides **graduated[485] interest rate withholding tax exemptions** to foreign lenders who provide long-term loans to local businesses (*see Table 3.1 below*).[486] The relevant provisions[487] grant withholding tax exemptions ranging from 40% through to 100% depending on the term of the loan, with tenors of 7 years and above attracting total exclusion of tax on interest payments.[488] Qualifying foreign loans arise where a foreign company grants the loan out of offshore, non-domestic funds (whether in Naira or not) brought into Nigeria from a foreign territory or country; where a foreign company grants a loan offshore in a territory or country other than Nigeria, and grants the funds in a foreign currency;[489] or possibly where the credit obligation is repayable in a foreign currency.[490]

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481 Under the liberalised foreign exchange laws, private persons are permitted to hold and trade in foreign exchange; one of such liberties is the operation of local domiciliary accounts denominated in foreign currencies.

482 §23(1)(f),(l) & (m) CITA 1979.

483 Essentially funds remitted through the official foreign exchange markets operated by the Central Bank and authorised dealers in foreign currency under the relevant foreign exchange regulations.

484 §23(1)(j) and (k) CITA 1979.

485 §11(10) *ibid.*

486 There is no restriction placed on the form of business organisation or the type of commercial activity engaged by the borrower.

487 The pre-April 1, 1968 regime [§11(1) CITA 1979] seems to have expired giving way to the post-April 1, 1968 regime and §11(6), CITA 1979. The post-1968 regime more generous than the pre-1968 regime in that it reduced the length of the tenor required before the loan may qualify for exemptions.

488 §11 CITA 1979.

489 §11(8) *ibid.*

490 Nigerian Accounting Standard Board: Statement of Accounting Standard 7 (SAS 7): Accounting for the Effects of Changes in Foreign Currency Rates, ¶6.

TABLE 3.1

TABLE I, THIRD SCHEDULE, CITA 1979

TABLE OF TAX EXEMPTION ON INTEREST ON FOREIGN LOANS

Repayment Period including Moratorium	***Grace Period***	***Tax Exemption Allowed***
(i) Above 7 years *(down from 10 years pre-1968)*	Not less than 2 years	100%
(ii) 5-7 years	Not less than 18 months	70% *(up from 15%)*
(iii) 2-4 years	Not less than 12 months	40% *(up from 15%)*
(iv) Below 2 years	Nil	Nil

3.2.3.5. Capital Gains Tax Incentives

Some of the tax incentives noted in the preceding section (§**3.2.3.4**) apply with equal force to local investors. For instance, an indigenous corporate investor could claim tax exemptions for withholding taxes on dividends from unit trusts. [491] However, tax incentives for indigenous investors appear to be targeted more at 'active' direct investment in specific sectors[492] than at merely rewarding the bare act of investing in commercial activities. An exception to this trend is the targeting of incentives to local investors retaining foreign exchange earnings in local domiciliary accounts. This retention improves the external position of the economy, controls the appetite for foreign exchange and curbs demand in the parallel or 'black' market for foreign currency. Earnings[493] repatriated from foreign operations and interests earned on foreign

[491] §23(1)(f) CITA 1979.
[492] Particularly those restricted to indigenous investors (e.g. tax incentives for marginal fields' operators).
[493] *Viz.*, dividends, interest, rents and royalties.

currency domiciliary accounts held in Nigeria enjoy **withholding tax exemptions**.[494]

As noted above, **capital gains** are taxable under CGTA 1967. The relevant concept of 'disposal' is rather wide one.[495] Indeed, for disposals of assets situated outside Nigeria, both resident and non-resident alienating individuals[496] may be liable to tax on any amounts received in or brought into Nigeria.[497] Similarly, an alienating non-resident company[498] would be nonetheless liable to tax to the extent that any gains from such disposition are received in or brought into Nigeria.[499] CGTA 1967 provides certain **tax exemptions**. Local companies and individuals can claim exemptions in respect of non-capital incomes which would be chargeable under the income tax statutes.[500] Also, gains derived from the disposal of stocks and shares are fully exempt from capital gains tax.[501] Similar treatment is accorded gains from the disposal of interests in unit trusts. However, in respect of gains accruing to holders of unit trusts, the tax-exempt treatment is conditional on any proceeds of disposal being subsequently reinvested ('rolled-over') into new securities.[502]

Finally, there is the possibility of institutions providing banking, stock exchange, insurance, reinsurance and other financial services qualifying for the

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494 §23(1)(k) and (m) CITA 1979.

495 Encompassing the sale, transfer, or other disposition of assets such that where any capital sum is received in return for the surrender of rights, or the refraining from exercising such rights, the recipient of value may be liable to capital gains tax: §6(1)(d) CGTA 1967.

496 Even though resident in Nigeria for a temporary purpose without intending to establish any permanent abode.

497 However, liability for a non-resident individual would arise only if, in any 12-month period, he is present in Nigeria for more than 182 days. However, even where an alienating individual qualifies as a taxable person under this 182-days residence rule, tax would only be chargeable to the extent that any gains are received in or brought into Nigeria: §4 CGTA 1967.

498 Not being a company incorporated, managed and controlled in Nigeria under CAMA 1990.

499 §4 CGTA 1967.

500 Notably the PITA 1993, PPTA 1969 and CITA 1979: §12 CGTA 1967.

501 §31(1) CGTA 1967.

502 §32B CGTA 1967.

extensive tax exemptions provided by NEPZ Act 1992.[503] This regime is considered in detail below but appears to encourage the development of **financial services centres** targeted at multinational groups and international financial institutions. However, in the absence of basic infrastructure, uninterrupted power supply, increased security and higher levels of ICT skills in the local workforce, it remains to be seen how tax incentives, without more, can serve as an effective catalyst for the development and growth of finance and other centres based in these EPZs.

This section has considered the scope of tax incentives applicable in the financial sector for institutions (e.g. banks and insurance firms) and instruments (e.g. bonds and equities). Financial sector reform has been a key theme under NEEDS and tax incentives policy has featured in a number of strategies to improve financial infrastructure. The next section reviews fiscal incentives targeted at activities that directly address physical infrastructure.

3.2.4. INFRASTRUCTURE & SERVICES

3.2.4.0. **Introduction**

The lack of adequate infrastructure and services has been a major obstacle to economic development. Public provision of basic services such as electric power supply, telecommunications, postal services, transportation networks, sewage and refuse disposal, portable water, healthcare and education has deteriorated. Indeed, the Nigeria PSA Report observes that infrastructure constraints were cited as the most common deterrent to investment by manufacturing firms surveyed, ahead of access to finance and business uncertainty.[504] Similarly, NEEDS notes the adverse impact that poor roads, epileptic power supplies and inadequate water resources have had on economic development. Key strategies under NEEDS have been privatisation and

503 These include indefinite exemptions from all federal, state and (local) government taxes, levies, rates and customs duties: §§8, 12 & 18 of, and Third Schedule to NEPZ Act 1992.

504 Nigeria PSA Report, pp.20;31.

liberalisation to promote the provision of some infrastructure and public goods/services by a competitive, well regulated private sector.[505] The next section considers how tax incentives have been (and are proposed to be) used to improve the provision of infrastructure and basic services by encouraging private sector participation.

3.2.4.1. TELECOMMUNICATIONS

3.2.4.1.1. Overview

The lack of effective and affordable telecommunications has been a major disincentive to investment and economic growth, ranking behind the poor electrical power supply as one of the key infrastructural shortcomings cited by manufacturing firms in the Nigeria PSA Report.[506] In 1998, waiting times for fixed phone lines provided by the telecommunications utility (Nitel) were on average 3½ years. Nitel's services were also unreliable and expensive. Fixed and mobile phone line teledensity was 0.40 per 100 persons and 1 per 10,000 persons respectively, ranking among the lowest in Africa.[507] Only 400,000 fixed lines were operational out of an installed public network capacity of 700,000 lines.

Significant changes have occurred since the introduction of the National Telecommunications Policy in September 2000 by the Ministry of Communications and the Nigerian Communications Commission (hereafter: NCC).[508] A crucial reform was the successful auctioning of ten-year digital mobile licences in January 2001 to 2 private operators and Nitel's mobile subsidiary, Mobile Telecommunications Ltd (M-Tel). The private operators,

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505 Other strategies proposed include public-private finance initiatives, build-operate-and-transfer, build-operate-own-and-transfer, rehabilitate-operate-and-transfer and concessioning: NEEDS Report, Chapter 5: Creating a Competitive Private Sector, p.59.

506 Nigeria PSA Report, pp.107-110.

507 Africa had on an average 2.24 fixed lines per 100 persons and 45 mobile lines per 10,000 persons. (Statistics are from the NITEL 1998 Annual Report, cited in the Nigeria PSA Report, p.99).

508 Established under the *NCC Act No. 75 of 1992*. The legal basis for recent reform has been the *Nigerian Communications Act of 2003*.

MTN Nigeria Communications Ltd (MTN)[509] and Celtel Nigeria (Zain)[510] paid US$285million each for the licenses and have invested significantly in building mobile networks spanning the entire country.[511] In 2003, a second national operator, Globacom Networks, commenced operations by competing with MTN and Celtel in the provision of mobile telephony services.[512] 25 fixed wireless access operators and 21 fixed line operators have also been licensed adding 520,000 fixed telephone lines to the national grid between 1999 and 2004. The aggregate number of phone lines has grown from 450,000 fixed and 25,000 analogue mobile lines in May 2005 to 1.2million fixed and 12.8million digital mobile lines in May 2005.[513] By August 2007, the telecommunications market subscriber base was estimated at 45.5million mobile, fixed and other lines.[514] The telecommunication revolution has resulted in more competition, better quality of service, increased teledensity, reduced waiting times (from years to minutes) all driving down the prices of tariffs and products.[515] The

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509 The Nigerian subsidiary of the South African based, MTN Group which is a leading telecommunications multinational with operations in Cameroon, SA, Swaziland, Uganda, as well as Nigeria.

510 Celtel Nigeria originally was Econet Wireless Nigeria Ltd (and later Vmobile) and after initial shareholder action currently is owned by indigenous public and private investors. Celtel originally invested US$650million in Nigeria and recently concluded a US$1.1billion project financing to further expand its mobile network <http://www.vmobile-nigeria.com/about.htm>, and <http://www.vmobile-nigeria.com/shownews.php?newsid=59> accessed 20.06.06.

511 MTN has spent US$1.8billion building the largest GSM telecommunications network and infrastructure in Nigeria. MTN estimates that US$3billion would be required in capex and opex investment to overcome infrastructural deficiencies <http://www.mtnonline.com/corporate/about.asp> and <http://www.mtnonline.com/corporate/press.asp?NewsID=22> accessed 20.06.06.

512 Globacom Networks is an indigenous firm owned by the Nigerian industrialist Mike Adenuga. As the second national carrier, Globacom is also licensed to provide fixed line, wireless and internet gateway services: <http://www.gloworld.com/GloMobile/About/GloMobile.htm?NavItemID=GloMobile&Cn=GloMobile> accessed 20.06.06.

513 E. Ndukwe, Telecommunications in Nigeria: the Next Frontier (a paper presented by E. Ndukwe, CEO, NCC at the New Age/NCC Seminar in Lagos on 31.05.05) accessed on 20.06.06 at <http://www.ncc.gov.ng/speeches_presentations/EVC's%20Presentation/Telecommunications%20in%20Nigeria.pdf>.

514 'Telecoms Subscriber Base Hits 45.5m,' *This Day* [newspaper report by Shina Badaru], 29th October, 2007 <http://www.thisdayonline.com/nview.php?id=93648> accessed 29.10.07.

515 For instance, the price of mobile starter packs dropped from ₦20,000 (US$145) on 2001 to N1 (less than 1 US cent) in 2004: see generally, Trends in

improved investment climate has resulted in communications-FDI increasing from US$5million (1999) to US$7.5billion (2005).[516]

3.2.4.1.2. **Tax Incentives**

Multiple taxation has been a major disincentive to investment and few sectors feel the burden of the taxes, charges and levies imposed by the three tiers of government as much as the telecommunications industry. Mobile telephony operators have consistently complained of double taxation, arbitrary local charges on communications masts and high duties on imports of essential equipment.[517] However, there has been some relief for private telecommunications firms from tax incentives provided under the ID/ITR Act 1971.[518] MTN and Vmobile were granted **pioneer status** in 2001 and enjoyed **5-year tax holidays**[519] despite criticism that the holidays were too generous given the level of financial success achieved by the firms within their initial years.[520] M-Tel, Globacom and 2 other communications firms were also granted pioneer tax holidays in 2004.[521] Pioneer period **capital allowances and tax losses** may be carried forward by these firms into the post-pioneer period presenting

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Telecommunications Markets in Nigeria 2003-2004 (Abuja, Nigerian Communications Commission, 2005).

516 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Nigeria)* p.443.

517 Goodluck, Wale Multiple Taxes and Levies-The Need for Harmonisation (The Telecoms Experience), a presentation by W. Goodluck, General Manager, Commercial/Legal, MTN Nigeria Communications Ltd at the Nigerian Bar Conference, Abuja, 30.08.05.

518 Item 33 of the *Industrial Development (List of Pioneer Industries) S.I. No.9 of 1982* provides for the 'manufacture of telecommunications equipment, cables, etc'. It is assumed that this includes the provision of telecommunication services though, as further examined in Chapter 7, tax incentive legislation tends to be rather subjective and may differ in application from the strict wording of the statute books.

519 In this Researcher's opinion, the 5-year tax holidays were improperly granted by NIPC: see below at **§7.4.3.3**.

520 MTN Nigeria attracted media censure over its 5-year tax holiday despite significant earnings, generating gross revenues of N119billion (R5.87billion) in the 6months to 30.09.05: see 'GSM: Five-Year Tax Holiday Still in Force, Says MTN CEO', *This Day* [newspaper report by Kletus Akwaya], 5th June, 2006 <http://www.thisdayonline.com/nview.php?id=19240> accessed 07.02.07; 'MTN Nigeria Earns ₦119bn in 6months', *This Day* [newspaper report by Tayo Ajakaye], 24th November, 2005 <http://www.thisdayonline.com/nview.php?id=34198> accessed 06.02.07.

521 Table 7.2.3.1: Pioneer Status granted to Companies in 2004, NIPC Annual Report 2004, pp.56-59 cf. Item #69, List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

desirable opportunities for large tax savings given the vast sums expended on capex and opex in establishing telephone networks.[522]

Telecommunication incentives are consistent with NEEDS economic policy which seeks to use both financial and fiscal incentives to promote private sector investment in the information and communications sectors.[523] While the generosity or otherwise of these tax holidays is debatable, it is only fair to note that at the time the mobile telephony operators were licensed, few foreign investors were willing to enter the Nigerian telecommunications market given the perceived high risk levels and the prevailing global investor apathy due to the failure of investments in third-generation mobile networks in Europe.

Nevertheless, telecommunications has remained a profitable economic sector recently attracting the second-largest share of FDI [524] with some operators recording bumper revenues. [525] Telecoms firms still operate in a challenging investment environment. Nitel's inadequate transmission facilities, poor infrastructure and transport networks, a lack of physical security for installations, concerns over currency exchange rates and the multiplicity of government taxes are often cited as key disincentives.[526] Large sums of capital are required compensate for these infrastructural shortcomings, particularly to overcome inefficiencies from poor electricity supply. [527] The next section considers the role of tax incentives in improving electricity supply and transportation networks.

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522 §11 and 14, ID/ITR Act 1971.
523 NEEDS Report, Chapter 6: Sectoral Strategies, pp.72-73.
524 Aggregate FDI in telecommunications has risen from US$50million in 2000 to US$10billion in 2006. Only the energy sector attracted more FDI in 2006.
525 MTN recently announced revenues of ₦177.8billion (US$1.4billion) in 9 months: see 'MTN Nigeria Earns ₦178billion in 9 months', *This Day* newspaper article by Taye Ajakaye and Frances Ovia], 9th March, 2006 <http://www.thisdayonline.com/nview.php?id=42603> accessed 09.03.06.
526 Wale Goodluck, 'Multiple Taxes and Levies-The Need for Harmonisation: The Telecoms Experience', *op cit.*
527 In 2003, US$140million (NGN18billion) committed to provide generator sets for base stations and other telecommunications facilities in Nigeria: see PR 25.02.03 http://www.mtnonline.com/corporate/press.asp?NewsID=22 and http://www.mtnonline.com/corporate/press.asp?NewsID=16.

3.2.4.2. POWER & TRANSPORTATION

3.2.4.2.1. Electric Power

The lack of reliable, cheap and efficient power supply is the investment challenge most commonly cited by investors. The sector has been dominated by the power utility company, the Power Holding Corporation of Nigeria (or PHCN; formerly known as NEPA) which operates as a vertically integrated monopoly. PHCN/NEPA is notoriously inefficient with frequent power outages, tension fluctuations (causing damage to equipment, property and goods), poor administration (particularly billings and debt collection) and corruption being the norm.[528] The manufacturing and service sectors are particularly affected by the power deficiency. The Nigeria PSA Report notes that the vast majority of manufacturing firms surveyed resorted to more expensive private power generation 67% of the time on average. Indeed, investment in power generation equipment accounted for 22% of capex on average tying up scarce financial resources. Other responses observed included factor and product substitution[529] and reduced output.[530]

The decline of the power sector peeked in 1999 when the lowest capacity of under 2,000MW/day was recorded. Current reforms focus on increasing the national grid's capacity from the present 4,000MW/day to 10,000MW/day by the end of 2007 and reaching at least 60% of the population with uninterrupted power supply.[531] NEEDS places emphasis on liberalisation, privatisation and more public-private collaboration to improve power generation, distribution, transmission, marketing and tariff collection. Legal and regulatory reform revolve around a new power sector policy and the *Electric Power Sector Reform Act of 2005*. The PHCN is to be unbundled into 18 distinct entities[532] with public holdings of thermal generation, distribution and hydropower facilities

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528 It is commonly joked that the acronym NEPA stands not for the National Electric Power Authority but rather 'Never Expect Power Always' and PHCN stands for 'the Problem Has Changed Names.'

529 That is substituting less power-intensive inputs, outputs and processes often at the cost of reduced productivity and value.

530 Nigeria PSA Report, pp.33-37.

531 NIPC Annual Report 2004, p.22.

replaced by private operators or rehabilitate-operate-and-transfer-back concessions. Sector policy and regulatory powers are to be vested in the National Electricity Regulatory Commission.

17 private independent power providers have been licensed and some of these have commenced operations in Lagos and Abuja.[533] Geometric Power Limited pioneered emergency power plants in Abuja and was granted pioneer status tax incentives. Geometric has concluded plans to operate a 140MW Independent Power Plant to be located in Aba (the centre of trade in Eastern Nigeria).[534] Active indigenous firms in the power sector include Kotco Power Ltd[535] and Gaslink Nigeria Ltd[536] which both were awarded **pioneer status tax incentives** in 2004.[537] However, it is unclear how beneficial 5-year pioneer tax holidays would be to greenfield independent power projects as these ventures typically take 4-6years to develop and even longer to generate taxable profits.[538] Besides the associated **tax holidays**, these firms would be entitled to post-pioneer period **capital allowances and tax losses** on the expenditures required to establish and operate their facilities.[539]

The next section considers the use of tax incentives to promote development by improving local and international transportation linkages.

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532 I.e. 6 (private) generation companies, 1 (state-owned) distribution company and 11 (private) transmission companies are proposed.

533 The Enron/AES Barge Nigeria Ltd has operated a 1270MW capacity barge in the Egbin area of Lagos. Likewise Geometric Power Inc and Aggreko International Projects Ltd now operate in Abuja.

534 'World Bank, Geometric Partner in N16bn Power Project', *This Day* [newspaper report by Kunle Aderinokun], 17th July, 2006 <http://www.thisdayonline.com/nview.php?id=53357> accessed 17.07.06.

535 Kotco Power Ltd specialises in electricity transformers and operates a joint venture company with Asian/Indian investors.

536 Gaslink Nigeria Ltd is a subsidiary of the indigenous energy firm, Oando plc and specialises in the supply of commercial and industrial gas.

537 Table 7.2.3.1: Pioneer Status granted to Companies in 2004, NIPC Annual Report 2004, pp.56-59.

538 'Nnaji: Why Independent Power Projects Are Delayed,' *This Day* [newspaper report by Chika Amanze-Nwachukwu], 23rd January, 2008 <http://www.thisdayonline.com/nview.php?id=93648> accessed 23.01.08.

539 §§11 & 14, ID/ITR Act 1971.

3.2.4.2.2. Transportation

Compared to neighbouring West African countries, Nigeria's transportation network is relatively well developed with the vast majority of goods and passengers being transported by road.[540] In the past, Nigeria's network of federal and state owned **roads** suffered from low investment, poor maintenance and neglect reducing the accessibility of produce from rural areas to local markets and major ports. The federal road network is currently being refurbished under the Operation 500 Roads project. The outmoded 3,505km **rail system** is being rehabilitated and upgraded with assistance from Chinese engineers prior to the privatisation or concessioning of Nigerian Railways.[541]

There are several international airports (including the Lagos, Abuja and Kano airports), half-a-dozen local airports and numerous private and military aerodromes. Unfortunately, the dearth of adequate facilities and equipment in the **aviation sector** has been the cause of several tragic air disasters in recent years.[542] Nigeria's main **seaports** are located in the southern cities of Lagos, Port-Harcourt, Warri and Calabar and were previously operated by the Nigerian Ports Authorities. Current reforms have seen concessions for 21-odd seaport terminals granted to private local and international operators generating substantial fee income for the government. Similarly, the government-owned shipyard and fabrication corporation, Nigerdock, was privatised by the sale of controlling interest to private investors in 2001.

NEEDS appreciates the numerous deficiencies in the transportation sector and seeks to implement a raft of strategies designed to coordinate public and

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540 Linda van Buren 'Nigeria: Economy', *Africa South of the Sahara 2005 34th Edition*, (Europa Publications/Taylor & Francis Group, London/New York: 2005) pp.858-859.

541 'Mining Needs $5bn to Rehabilitate Railway Sector', *This Day* [newspaper report by Onyebuchi Ezigbo], 12th September, 2005 <http://www.thisdayonline.com/nview.php?id=28060> accessed 13.09.05.

542 2005 ended with two air crash disasters involving a Bellview Airlines Boeing 737 (on 22.10.05) and a Sosoliso Airlines DC-9 (on 10.12.05) resulting in the loss of 117 and 100 lives respectively. Critics have attributed the poor safety record to inadequate facilities and the lax regulation of operators. NEEDS proposes greater radar coverage, new equipment and better facilities to address these concerns.

private initiatives to resolve these shortcomings.[543] A key aspect of NEEDS' strategies is the use of **private-public partnerships** to finance and manage the enhancement of local infrastructure. The necessary legal environment to facilitate such private participation is to be supported by the *Infrastructure Concession Regulatory Commission (Establishment, etc) Bill of 2004* and the *Build-Operate-Transfer (Regulatory) Commission Bill of 2005.* Both Bills will establish regulatory commissions to supervise the grant of concessions to private concerns investing in transportation, power, telecommunications, transportation, water supplies, sewage disposal and other basic services.

3.2.4.2.3. **Tax Incentives for Power and Transportation**

Traditionally, the main tax initiatives for infrastructural development were the **rural investment allowances** for capex incurred on the provision of tarred roads, electricity supply and portable water for the purpose of a trade or business in remote geographical areas. Such areas must be located at least 20km away from public infrastructural facilities. Rural investment allowances give investors **enhanced or multiple deductions** ranging from 5% (telecommunications), 15% (roads), and 50% (electricity) to 100% on qualifying capex.[544] **Modest capital allowances** are granted for capital investments for infrastructural facilities including those associated with shipping, railways and portable water, regardless of geographical location.[545] Tax incentives are not restricted to investments in long-term fixed assets. CITA 1979 provides incentives for investments in shorter term assets by transportation firms.[546] Firms engaged in public transportation may claim **initial allowances** as **accelerated depreciation** of 95% of capex incurred in procuring vehicles.[547]

543 NEEDS Report, Chapter 6: Sectoral Strategies, pp.59-60.

544 §34 CITA 1979.

545 Comprised by 15% first year initial allowances followed by 10% annual allowances for docks, wharfs, piers, jetties and ancillary facilities; public railways; and facilities for the supply of portable water: see ¶5 of, and Tables I & II to the Second Schedule to CITA 1979.

546 Most transportation firms would be liable to corporate tax under normal rules. However, special rules apply for firms engaged in shipping and air transportation: §14 CITA 1979.

547 ¶6 of and Table I to the Second Schedule, CITA 1979.

In the 1970s/1980s, power generation, transportation and telecommunication projects were not treated as preferred activities deserving of pioneer industry tax holidays.[548] However, it appears that the dearth of these aspects of infrastructure and the adverse effect their absence has had on investment and growth influenced the change in fiscal policy. Under NEEDS, the strategy is to encourage private sector solutions to these infrastructural challenges. Currently, under an extended list of pioneer industries provided by NIPC investments in the following sectors are eligible for **3 to 5-year tax holidays**:[549] gas manufacture and distribution; manufacture of solar-powered equipment; bitumen mining and production; manufacture of lubricants; and the provision of utility services including independent power generation projects utilising gas, coal and renewable energy sources, all aspects of transportation including rail, road and waterways, and indigenous telecommunications companies other than GSM mobile telephony operators.[550] This appears to be consistent with the Ministry of Finance's policy under the draft National Tax Policy to target tax holidays precisely to ensure that vital private sector investments in the power, railways, roads, aviation, gas and other key sectors are encouraged.[551]

This section has highlighted tax incentives that are available for vital investment in local infrastructure which is necessary to improve the investment climate for manufacturers and other businesses. The next sections examine tax incentives directly targeted at these manufacturers, focussing first at macro-enterprises and then at micro-enterprises.

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[548] As underscored by the absence of these activities on the original list of pioneer industries (Schedule to ID/ITR Act 1971). These utilities had not been privatised and public monopolies were statutorily protected.

[549] NIPC has in the past advertised and awarded 7-year tax holidays for pioneer industries sited in economically disadvantaged rural areas. However, the legislative authority for these incentives is obscure and it would appear that any such incentives were awarded in error: Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

[550] Items #44, 45, 47, 53 and 69, List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, p.8.

[551] 'IMF Comments on FGN Tax Strategy: FGN Strategy and Position on Issues Raised,' Power Point Presentation of January 24, 2007 (Budget Office of the Federation, Abuja: 2007), slide 3.

3.2.5. MANUFACTURING & INDUSTRY

3.2.5.0. Overview

Reliable data and statistics on the recent performance of Nigeria's industrial and manufacturing sector are hard to access. However, NEEDS observes that results have been well below the sector's potential to create wealth and increase employment.[552] Firms vary from state-owned parastatals and heavy industry,[553] small and medium-scale indigenous manufacturing enterprises, medium-sized Lebanese and Asian owned companies[554] to large Western multinationals. The import substitution policies of the 1970s provided the initial impetus for large-scale industrialisation supported further by protective tariffs. Due to the 1980s structural adjustment policies, many manufacturers who relied heavily on imported inputs were adversely affected by the devaluation of the Naira. This resulted in a decline in manufacturing by a third between 1982 and 1985 severely affecting the vehicles' assembly, chemicals, metals, textiles, sugar, plastics and paper sectors. In 1986 firms reliant on local inputs recorded high levels of capacity utilisation but in 2003 manufacturing comprised only 4% of GDP due to levels of low capacity utilisation.[555] However, due to an improving investment environment, manufacturing GDP grew by over 9% in both 2005 and 2006.[556]

The Nigeria PSA Report gives an overview of some key issues regarding industrial. In particular, the relatively low level of value-added per worker is a significant factor, attributable to the ownership of firms,[557] the relevant

552 NEEDS Report, Chapter 6: Sectoral Strategies, p.70.
553 Such as the Delta Steel Co., the Ajaokuta Steel Co. and the Aluminium Smelter Co. of Nigeria. However, the government is seeking to divest its interest in these concerns under the current privatisation policy.
554 Forrest, *The Advance of African Capital*, *op cit*, p.242.
555 Van Buren 'Nigeria: Economy', *op cit*, p.857.
556 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Nigeria)* p.443.
557 The Report notes that foreign-owned firms (i.e. firms with European, Asian and Middle Eastern entrepreneurs) had significantly higher levels of value-added per worker (due in part to the lower levels of workers employed): Nigeria PSA Report, pp.9-10.

industrial sector,[558] local labour market dynamics,[559] the overvalued Naira and the high proportion of non-productive, 'white-collar' workers in industry.[560] A significant proportion of large manufacturing concerns focus on import-substitution and the relatively high levels of tariff protection tend to shield these firms from international competition, often reducing efficiency.[561] Other impediments to industry include the infrastructural inadequacies noted in the preceding section, onerous business regulations, rule of law challenges, inconsistent and unpredictable economic policies, security concerns and a prevailing environment of low business ethics/trust. The **tax system** has also been criticised by industry as being unduly complicated, with a multiplicity of local, state and federal levies which are often arbitrarily administered.[562]

NEEDS notes that the key challenge to increased industrial productivity lies in increasing the levels of local value-added in goods and services to move beyond the supply of primary products to the manufacture and processing of internationally competitive intermediate and finished goods. Local manufacturers have been harmed by unfair competition from dumped, substandard and smuggled goods.[563] Similarly, prevailing legal, financial and infrastructural deficiencies have undermined the nation's industrial base. NEEDS proposes the following solutions: increasing the levels of local value-added by emphasising knowledge and skill-based industries; increasing the local

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558 Food processing exhibited higher levels of value-added per worker than other sectors (including chemicals, paper, textiles and wood processing): Nigeria PSA Report, p.8.

559 The Report compares local labour market conditions with those of Asian economies at comparable stages of development. It suggests that Nigeria exhibits relatively lower productivity and higher wage levels, attributable to lower man: land ratios and greater unionisation of the workforce: Nigeria PSA Report, pp.15-16.

560 *Ibid.*

561 The Report, however, notes that the decline in employment in larger manufacturers during the 1980s/1990s period of structural adjustment may reflect increasing efficiency: *ibid*, pp.8-9;15-16.

562 Nigeria PSA Report, pp.42-51. See also 'Multiple Taxation Prevents Industrial Revolution', *This Day* [newspaper report by Crusoe Osagie], 6th March, 2006 <http://www.thisdayonline.com/nview.php?id=42408> accessed 02.05.06.

563 See 'Dunlop Records a ₦36.9m Loss', *This Day* [newspaper report by Jerome Ushakang], 23rd August, 2005 '<http://www.thisdayonline.com/nview.php?id=26074> accessed 19.01.06.

science and engineering capacity; and increasing private sector investment to replace the government's dominance in industry.[564]

3.2.5.1. Tax Incentives for Manufacturing

The corporate tax code is replete with numerous tax incentives to encourage manufacturing and industry. Existing tax incentives for capital investment range from modest **industrial building investment allowances**[565] to very **generous capital allowances** by way of **initial allowances** allowing the immediate write off of industrial **research and development expenses.**[566] Other incentives include the **removal of the normal restriction**[567] on the quantum of capital allowances claimable in a particular year of assessment.[568] Indigenous manufacturers of spare parts, tools and equipment for the domestic or export markets are eligible for a 25% **investment tax credit** calculated on qualifying capex against taxable profits provided they engage in no other business. Similarly industries that patronise such locally manufactured plant, machinery or equipment are allowed a 15% **investment tax credit** on the acquisition costs of such assets.[569] The replacement of obsolete plant and machinery with more modern equipment is rewarded with a 15% **investment tax credit.**[570]

A central policy in the industrialisation strategies of the 1970s/1980s was the promotion of both import-substitution and capital-intensive heavy industry. This policy's imprint is still discernable in the **pioneer industry tax holiday**

564 NEEDS Report, Chapter 6: Sectoral Strategies, pp.70-72.

565 15% first year initial allowances and subsequent 10% annual allowances are granted for industrial structures including mills, factories, mechanical workshops and ancillary facilities: ¶¶5 & 8 of and Tables I & II to the Second Schedule, CITA 1979.

566 Industrialists may immediately deduct 95% of qualifying expenditure incurred on equipment and facilities, patents, licences, secret formulas or processes, industrial, commercial or scientific information, technical feasibility studies and other R&D costs in computing taxable profits: see ¶(1)(1)(f) of; and Tables I & II to the Second Schedule, CITA 1979.

567 Under normal corporate income tax rules, companies may not claim allowances in excess of 66 2/3% of assessable profits in any year of assessment.

568 ¶24(7) of the Second Schedule, CITA 1979. This incentive is exclusive to the manufacturing and agro-allied sectors.

569 §38 (1)&(2), CITA 1979 respectively.

570 §41 CITA 1979.

provisions in the ID/ITR Act 1971. Crucially, out of the **37 categories** of eligible activities enumerated in Schedule to the Act, 26 relate to manufacturing and industry. Eligible activities include salt processing; smelting and refining of iron, steel and alloys; manufacturing industrial inputs for the energy sector; manufacturing infrastructural inputs such as cement, glass, marble, ceramic products, telecommunication equipment, building materials and stationery; solid minerals processing; processing industrial chemicals; processing yeast, alcohol, animal feedstuff, cocoa and other plantation crops; manufacturing science, educational, medical, dental and pharmaceutical supplies or equipment;[571] processing paper, metals, textiles, leather and rubber; and the local fabrication of industrial machinery and automobile parts.[572]

However, NIPC has furnished an **extended list of 69 pioneer industries** eligible for fiscal incentives.[573] The legislative authority for this extended list is unclear as the additional industries listed are not provided for anywhere in the ID/ITR Act 1971. However, under §1 of the ID/ITR Act 1971, the President may by publication in the government's Gazette, increase or otherwise amend the list of pioneer industries and products. It is possible that the list has been extended by Gazette but the Schedule to the Act has not been amended accordingly to reflect this.[574]

NIPC's extended list expands the scope of manufacturing and allied industries qualifying for pioneer status.[575] Notably, the list now includes the manufacture

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571 Medical and pharmaceutical products are also VAT-exempt: see the First Schedule to VATA 1994.

572 Schedule to the ID/ITR Act 1971.

573 List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

574 This Researcher was unable to establish the exact Gazette or other authority for NIPC's extended list, despite numerous enquiries at NIPC and FIRS made during field trips to Nigeria. This reoccurring theme of obscure, inadequate and inaccessible legislative or regulatory authority for various aspects of Nigeria's tax incentive policy, and the adverse effect this has on transparency and accountability is further explored in Chapter 7.

575 Curiously, the manufacture of medical and dental equipment; office and school stationery; and building and home furnishing materials all seem to have been deleted in NIPC's extended list: cf. items #35, 36 and 37 of the Schedule to the ID/ITR Act 1971.

of nets, gas cylinders, fertilizers, gypsum, flat sheets, welding electrodes, nails and brewing hops; and the processing of wheat, gum Arabic, waste oil, enzymes and concentrates. In addition, eligible engineering activities include the manufacture of electrical appliances and components, marine equipment and vessels, computers, cameras, underwater diving equipment, aircraft facilities, agriculture equipment, heavy-duty lifting equipment and foundries; and the installation of aircraft facilities, scientific instruments and communication equipment.[576]

Under the ID/ITR Act 1971, the initial **3-year tax holiday** may be **extended by 2 additional years yielding a maximum cumulative holiday of 5 years** subject to satisfactory performance based on criteria including the rate of industrial expansion, the level of efficiency and development, the firm's effectiveness in implementing any schemes relating to raw material utilisation or training of indigenous staff and the general importance of the industrial activity to the economy.[577] However, **in practice** it appears that NIPC has in the past **irregularly awarded 7-year tax holidays** comprising a **5-year initial period followed by a 2-year extension in contravention** of the express provisions of the ID/ITR Act 1971.[578] The source of the confusion which led to this development is not clear. However, NIPC presently accepts that tax holidays under the Act should not be awarded for more than a cumulative period of 5 years.[579]

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576 List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

577 §10 ID/ITR Act 1971.

578 NIPC states in its advisory brochure that *7-year tax holidays* may be granted to investments in 'economically disadvantaged local government areas', cassava projects, manufacture or installation of telecommunication equipment, electrical power supply and transportation: see Investment Incentives in Nigeria Brochure, *op cit*, pp.1,8,10,16. These statements are clearly contrary to §10, ID/ITR Act 1971 which limits tax holidays to a maximum of *5years*. Indeed, the relevant provision of the CITA (§34) dealing with investments in disadvantaged local government areas provides for capital allowances by way of a rural investment allowance and *not* tax holidays.

579 This was established in personal conversations between this Researcher and NIPC officials in January 2007.

Net business losses and **capital allowances** relating to eligible capex may be accumulated during the tax-free pioneer period and carried forward into the post-pioneer period to reduce taxable profits.[580] As such, the benefit of these rules under the normal corporation tax rules is preserved. Shareholders benefit from **withholding tax exemptions on dividends** paid from tax-free pioneer period profits, provided such profits are credited into a special account.[581] These provisions are targeted at firms that prove to be profitable within the initial 3 or 5 years.[582] However, companies are prohibited from making (reverse) loans during the pioneer period without due approval under an anti-abuse measure.[583]

The rationales behind the ID/ITR Act 1971 are as noble as the pioneer period incentives are generous. However, the reality may be that these incentives have had limited impact on the expansion of Nigeria's industrial base due to conceptual defects in the import-substitution/economic growth-by-industrialisation paradigm and practical problems with targeting incentives. The outcomes have been high redundancy rates and excessive revenue losses. NEEDS proposes to review and codify the existing **tax incentive system**, design **incentives to promote export-oriented production and manufacturing** and introduce more sophisticated tax incentives specifically targeted at science, technology and R&D including **enhanced and accelerated deductions** for related expenditures.[584] This trend towards export-oriented incentives is highlighted in the next section.

3.2.5.2. Tax Incentives for Exports: Tax-Free Zones

A key aspect of the draft National Tax Policy on the use of fiscal incentives is the intention to **target tax holidays** to encourage investments in specific

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580 §14 ID/ITR Act 1971.

581 It is unclear whether an accounting contra-entry would be sufficient compliance with this provision or whether a designated bank account must be set-up for this purpose.

582 §§16&17, ID/ITR Act 1971.

583 §18 ID/ITR Act 1971.

584 NEEDS Report, Chapter 6: Sectoral Strategies, p.72.

economic sectors including the **promotion of exports.**[585] This is consistent with the preference under NEEDS for **export processing zones or enclaves** as opposed to the reliance in the past on import-substitution manufacturing. This economic policy is clearly translated into legislative reality under the export processing zones provisions.

As noted above,[586] NEPZ Act 1992 provides a general regime for the establishment, operation and management of EPZs. NEPZ Act 1992 vests the President with the power to designate as EPZs such geographically delineated areas as may be recommended by the Authority established under NEPZ Act 1992 (hereafter: NEPZ Authority). NEPZ Authority may amend, vary, add to the limits or rename any EPZ[587] and is constituted by a managing director and representatives of various Ministries,[588] the Nigerian Customs Service, the Nigerian Ports Authority, the private sector and the CBN.[589]

Provisions similar[590] to those under OGEFZ Act 1996 provide that approved enterprises[591] are **exempt from customs duties,**[592] **import duties,**[593] **and all other Federal, State and (local)**[594] **government taxes, levies and rates including VAT.**[595] Approved enterprises may engage in trading, exhibition, assembly, manufacturing, processing, repackaging, storage, export and consumption of imported materials.[596] Retail trade must be with the express

585 'IMF Comments on FGN Tax Strategy: FGN Strategy and Position on Issues Raised,' Power Point Presentation of January 24, 2007, *op cit*, slide 3.
586 See §**3.2.2.1.7.** above.
587 §1 NEPZ Act 1992.
588 *Viz.*, of Commerce and Industry, Culture and Tourism, and Science and Technology.
589 §1 NEPZ Act 1992.
590 *Viz.*, §§8, 12 & 18 NEPZ Act 1992.
591 The NEPZ Authority is empowered to licence such enterprises and such licensing is deemed to constitute company registration under CAMA 1990; however, in practice the filing of returns with the Corporate Affairs Commission is required: §10 NEPZ Act 1992.
592 Ordinarily payable on the import of capital and consumer goods, raw materials and other intermediate components: §12 NEPZ Act 1992.
593 ¶1 *Customs Tariff (Exemption) Order 2001, S.I. No.18 of 2001.*
594 §8 OGEFZ Act 1996. It would appear that the omission of the word 'local' from this provision was a draftsman's error.
595 Part I, First Schedule to VATA 1993.
596 §12 NEPZ Act 1992.

permission of NEPZ Authority.[597] EPZs are treated as distinct zones outside the Nigerian customs territory and exports from EPZs to the rest of Nigeria must comply with local customs and licensing regulations applicable to normal imports.[598]

Ancillary non-fiscal incentives include free remittance of capital, profits and dividends targeted at foreign investors; a simplified import, export and licensing regime; rent-free land for facilities during the construction period; the prohibition of strikes and industrial action; no restrictions on foreign ownership of firms; reduced restrictions on the employment of expatriate staff; and provisions to facilitate trade finance and securitisation.[599]

These EPZ incentives are complemented by certain provisions of CITA 1979 providing **withholding tax exemptions** for dividends derived from wholly-export oriented businesses; **companies' income tax exemptions** on repatriated profits derived from exports of goods provided the proceeds are utilised for the purchase of raw materials, equipment and other inputs, or from supplies of inputs exclusively for export production;[600] and **100% annual capital allowances** on qualifying building and plant expenditure.[601] CITA also provides **3-year tax holidays** for wholly export-oriented undertakings sited within or outside EPZs.[602] However, it is improbable that any profit-maximising concern located within an EPZ would elect these time-bound tax waivers instead of the more generous indefinite tax holidays provided under NEPZ Act 1992.

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597 §17 *ibid.*
598 Sales of imports in the domestic customs territory are limited to 25% of production: §§14 & 18(1)(e), *ibid.*
599 §§18 & 12(4)(b), *ibid.*
600 §23(1)(p)-(o), CITA 1979.
601 These operate to exclude eligibility for normal investment allowances. §35(1)&(2), CITA 1979.
602 §35(3) CITA 1979.

The most successful tax-free zone has been the pioneering Calabar Free Trade Zone which was approved in 1989[603] but only became operational in 2000. Calabar Free Trade Zone is located in Cross River State and occupies 152-hectares of enclosed property adjacent to the Calabar Free Port. 60 companies have been registered in the Zone operating in textiles, food processing, pharmaceuticals, steel rolling, paints manufacturing and computer assembly. These enterprises are supported by power, postage, telecommunication and banking facilities in addition to customs, immigration, cargo handling and warehousing services.[604] Calabar Free Trade Zone will also serve as the investment platform for the establishment of Tinapa Business Resort.[605] Five other tax-free zones have been approved and are to be located in Northern Nigeria,[606] Lagos State[607] and Ondo State.[608]

The foregoing paragraphs have underscored the fiscal incentive regime for industrial activity focussing on manufacturing both for domestic and export markets. However, the organised manufacturing and industrial sectors, though vital for economic development and competitiveness, employ less people than the burgeoning informal sector. The next section considers tax incentives targeted at small and medium sized enterprises (or SMEs).

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603 Investors' Guide to Nigeria Brochure, *op cit*, Chapter 13: Free Trade/Export Processing Zone Scheme, p.87.

604 Broll Retail Projects and Tinapa Business Resort Limited; 'Tinapa Business Resort Limited: Africa's Most Exciting Leasing Opportunity' Brochure, Slide 5, <http://www.tinapa.com/html/downloads/downlaod.html> accessed 30.03.2007.

605 See below at **§3.2.8.2** of this Thesis.

606 *Viz.*, the Kano, Maigatari and Banki Free Trade Zones to be located in the northern states of Kano, Jigawa and Borno respectively: Investors' Guide to Nigeria Brochure, *op cit*, Chapter 13: Free Trade/Export Processing Zone Scheme, p.89.

607 The proposed Lekki Export Processing Zone is a private joint venture initiative between the Lagos State government and a consortium of Chinese businessmen, to occupy 1000hectares of property located at the Lekki peninsular. The project is to cost N2billion (or US$26.7million) and has the potential to generate 300,000 local jobs: 'Lekki Free Trade Zone to Create 300,000 jobs-Tinubu', *This Day*, 12th May, 2006 <http://www.thisdayonline.com/nview.php?id=47941> accessed 13.05.06.

608 Niyi Bello, 'Govt to relocate Naval base to free trade zone in Ondo,' *Nigerian Guardian* (Lagos 19.09.07) <http://www.guardiannewsngr.com/news/article06> accessed 19.09.07.

3.2.6. MICRO-ENTERPRISES & SMEs

3.2.6.0. Overview

The informal trading sector has always been a dynamic one engaging large numbers of people particularly in densely populated cities such as Lagos, Kano, Kaduna, Enugu, Ibadan and Port Harcourt. Some indigenous small-scale traders started from humble beginnings in formal apprenticeships and evolved into medium and large-scale manufacturing conglomerates.[609] Forrest notes that the expansion of some indigenous enterprises has been due to diversification and risk-reduction strategies to address high levels of risk in the commercial environment. Other responses to policy and macroeconomic risks include overinvestment in property holdings, the pursuit of short-term opportunities and reduced of long-term investment in fixed assets.[610]

The OECD and African Development Bank Nigeria note that while SMEs constitute 95% of Nigeria's organised manufacturing sector and provide 70% of the employment, they contribute less than 15% of industrial output.[611] SMEs suffer significant shortcomings compared to larger enterprises. [612] The challenges posed by infrastructural deficiencies fall disproportionately on small firms which are unable to utilise economies of scale to subsidise large investments in private power, transport and communication infrastructure. Similarly, the low levels of business trust, reduced influence with the government and public officials, and difficulties in enforcing contracts through often protracted judicial and arbitration procedures all place SMEs at a distinct disadvantage compared to larger firms.[613] It is no surprise that the cumulative effect of these difficulties is to reduce productivity. Indeed, the Nigeria PSA

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609 Forrest profiles numerous indigenous entrepreneurs (between the 1920s to the 1980s) who started out as traders and subsequently proved to be extremely successful industrialists, traders and transporters: Forrest, *The Advance of African Capital, op cit*, pp.233-234.

610 *Ibid.*

611 OECD/AfDB, *African Economic Outlook 2004/05 – Country Studies: Nigeria*, p.373.

612 Particularly in coping with poor electricity supplies: OECD/AfDB, *African Economic Outlook 2007: Country Notes (Nigeria)* p.443.

613 Value-added per worker was found to vary from US$3,859 for small firms (less than 100 employees), US$5,020 for medium sized firms (less than 200 employees),

Report observes that value-added is directly related to firm size with smaller and medium sized firms exhibiting significantly lower levels of value-added per worker than large and very large firms.[614]

NEEDS notes the economic significance of the informal sector and seeks to implement strategies to enhance its economic contribution. Policies are proposed to address low productivity and value-added, poor linkages with organised industry and research institutes, poor access to finance and infrastructural deficiencies that particularly affect SMEs. Strategies include developing clusters and industrial parks to promote linkages, improving access to finance through public financial institutions[615] and private financial initiatives,[616] introducing favourable pro-'local content' public procurement policies and encouraging joint ventures, partnerships and collaborations between local micro-enterprises and foreign investors.[617]

3.2.6.1. **Tax Incentives for Micro-enterprises**

A special agency known as SMIDA was established under the *Small and Medium Scale Industries Development Agency (Establishment) Act No. 16 of 2003*[618] (hereafter: SMIDA Act 2003) to promote pro-SME policies, rural industrialisation, poverty alleviation, support services, networks and related technology. SMIDA is responsible for developing 'cottage' industries and the SMEs sub-sector, and promoting sub-contracting, clustering, networks and linkages with other economic sectors.[619] SMIDA is empowered to **recommend** to the federal government applicable **tax and tariff regimes and other financial incentives**

US$4,198 for large firms (less than 500 employees) to US$11,094 for very large firms (over 500 employees): Nigeria PSA Report, p.6.

614 Nigeria PSA Report, pp.15-16.

615 E.g. from the Bank of Industry. Other initiatives such as the Family Economic Advancement Programme were less successful.

616 E.g. the Small and Medium Enterprise Investment Equity Scheme organised by the Bankers' Committee whereby banks are required to set aside 10% of their profit after tax for investment in SMEs.

617 NEEDS Report, Chapter 6: Sectoral Strategies, pp.70-72.

618 The Act establishes SMIDA with representatives from the 6 geo-political zones, with ex-officio members drawn from the public service (i.e. the Federal Ministries of Industry and Science & Technology; the National Planning Commission; and the Bank of Industry) and private sector: §§1&2, SMIDA Act 2003.

for promoting the development of small and medium scale industries.[620] Existing tax incentives targeted at SMEs include **rural investment allowances** for capex expended for providing infrastructural facilities in less developed regions.[621] **Dividends** from SMEs active in the manufacturing sector are **exempt from withholding tax** in the first five years of operation.[622] SMEs active in agriculture, mining and small-scale manufacturing are eligible for **pioneer industry tax holidays** and other tax incentives. However, companies granted the pioneer industry tax incentives under the ID/ITR Act 1971 are ineligible for the rural investment allowances.[623]

Special incentives apply under the *Venture Capital (Incentives) Act No. 89 of 1993* (hereafter: VC Act 1993) to encourage indigenous technologies and promote the growth of SMEs which involve the development and utilisation of local raw materials. VC Act 1993 provides unusual **capital allowances** permitting the **deduction of the cost of an equity investment** in eligible venture capital companies from the investor company's taxable income as assessed under CITA 1979. The applicable schedule is 30:30:20:10:10 effectively writing off the investor company's risky equity investment in venture capital company over 5 years of assessment.[624] Investments funded by the National Risk Fund attract similar incentives. **Withholding tax** on dividends paid by the Risk Fund is **reduced by 50%** from 10% under CITA 1979 to 5%.[625] Curiously, certain capital gains from the disposal by the investor company of its equity interest in the venture capital company are **exempt from capital gains tax** depending on the length of time the equity interest is held.[626] VC Act 1993 extends both

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619 §8 SMIDA Act 2003.
620 §8(t) SMIDA Act 2003.
621 Applicable to infrastructural capex to provide electricity, water, roads and telecommunications located in rural, underdeveloped areas. The allowances range from 5% to 100% on qualifying capex depending on the type of infrastructure provided: §34 CITA 1979.
622 §25(0) CITA 1979.
623 §19 ID/ITR Act 1971; §40(12) CITA 1979.
624 §4(a) VC Act 1993.
625 *Ibid.*
626 Gains realised within 5 years of the initial investment are completely exempt from capital gains tax; those realised between 6 and 10 years are suffer tax at 2.5% while

pioneer industry incentives under the ID/ITR Act 1971 and **export-promotion incentives** under the *Export (Incentives and Miscellaneous Provisions) Act No. 18 of 1986* to venture project companies.[627]

NEEDS proposes to introduce special incentives to promote linkages between the formal and informal sectors and streamline available tax incentives for SMEs.[628] However, the existing tax law is inconsistent, simultaneously featuring **tax incentives** and provisions which contain certain **tax disincentives** which may discourage SMEs from formalising their businesses and registering for tax. On the one hand is the **reduced corporate income tax rate of 20%** applicable to **small companies** engaged in manufacturing, agriculture, solid minerals mining and export trade with total gross sales/turnover of less than ₦1million.[629] On the other are the much vilified **minimum tax provisions** which levy tax on corporate profits based on various (arguably inappropriate) criteria including gross profit, net assets and paid-up share capital.[630] The minimum tax provisions are particularly bizarre as they may be applicable where a company is inactive or marginally profitable and the tax base criteria are wholly unrelated to net profits. However, agricultural, foreign and new companies that have not been operational for more than 4-years are exempt from the minimum tax. Companies can also exploit capital allowances and loss relief rules.[631]

Tax incentives are one of many strategies utilised to promote micro-enterprises. The Central Bank has increasingly made the provision of microfinance facilities a key policy point. A voluntary initiative by the Bankers'

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those realised between 11 and 15 years are taxed at 7.5%: §4(c) VC Act. The normal rate of capital gains tax under CGTA 1967 is 10%.

[627] §4(e) & (f) VC Act 1993.

[628] NEEDS Report, Chapter 6: Sectoral Strategies, p.72.

[629] The normal rate of corporation tax is 30%. Companies enjoy the reduced rate for an initial period of four years after commencement of business. The period may be extended by 2 additional years depending on evidence of good management and records: §40(7),(8) & (10) CITA 1979.

[630] §33 CITA 1979. The minimum tax provisions override the small companies' tax provisions.

[631] §33(3) & (4) CITA 1979.

Committee since 1999/2000 under the Small Medium Industries Equity Investment Scheme (SMEIES) urges banks to set aside 10% of their profits after taxation for equity investment in SMEs, either routed directly by the banks or through conduit venture capital companies.

Other sectoral initiatives support SMEs. Under the *Nigerian Minerals and Mining Act, 2007* (hereafter: NMMA 2007), small scale and artisan miners may be provided with certain extension services financed by the Solid Minerals Development Fund to support their operations.[632] Mining is a unique sector where much of the commercial exploitation of solid minerals has been conducted by the unregulated informal sector. The next section considers recent legal reform of this sector and highlights the tax incentives provided to promote private sector participation.

3.2.7. MINING & SOLID MINERALS

3.2.7.0. **Overview**

Mining in Nigeria has a distinguished pedigree, with historical records tracing this activity back to the 340 B.C. Nok culture and other ancient artisan civilisations.[633] Mineral resources including tin, columbite and coal were commercially exploited for export during the Second World War. The 1950s/1960s saw the major decline of the mining sector largely due to the rise of the petroleum industry and the Biafran War.[634]

However, under the Obasanjo and Yar'Adua administrations, the mining sector has assumed new prominence in efforts to diversify the economy. Current policies under NEEDS seek to address numerous constraints in developing and

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632 §§34 & 91, NMMA 2007.

633 Such as the Igbo Ukwu civilisation, the Hausa kingdom and the ancient City States of Benin and Oyo.

634 Federal Ministry of Solid Minerals Development's Mining Journal special publication, 'Nigeria: An Exciting New Mining Destination' (London, Mining Publications, 2006), p.5; <http://www.msmd.gov.ng/Publications/publications.asp> accessed 27.04.06.

exploiting mineral resources [635] by encouraging formal, private-sector investment in environmentally-sustainable exploitation; improving data management of mining rights, licences and leases by a cadastral register; improving poor working conditions, access to credit and health services for industry participants; and codifying a competitive range of fiscal incentives for investors.[636] World Bank funding was obtained for a Sustainable Management of Mining Resources Project involving significant reform of the mining sector.

3.2.7.1. Tax Incentives for Mining

The new NMMA 2007 replaces the previous *Minerals and Mining Act No.34 of 1999* effective from 16 March 2007.[637] As with energy resources, ownership rights to minerals are vested in the federal government on behalf of the Nigerian people.[638] The sector is regulated by the Minister for Mines and Steel Development whose duties place a strong emphasis on sustainable development.[639] Authorised persons may obtain numerous types of exploiting rights including reconnaissance permits, exploration licenses, mining leases, quarry leases, water use permits and small scale mining leases.[640]

Tax incentives are provided for license holders and other operators. **Capital allowances** by way of 95% first year allowances may be accumulated and utilised for up to 4-years before they expire[641] on certain qualifying capex.[642] Modest capital allowances may also be granted for industrial buildings utilised

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635 Notably, the informal nature of current mining activities; a dearth of local know-how and capacity to exploit resources; poor data and surveys of proven mineral deposits and an uncompetitive fiscal and regulatory regime.
636 NEEDS Report, Chapter 6: Sectoral Strategies, pp.77-79.
637 §161 NMMA 2007.
638 §1 NMMA 2007.
639 See §4 NMMA 2007.
640 Part IV, NMMA 2007.
641 §24 NMMA 2007.
642 Essentially certified exploration, development and processing expenditure including feasibility studies and sample assaying costs, and all infrastructural costs regardless of ownership or replacement.

in mining operations under CITA 1979.[643] **Loss relief carry forwards** may apply for certain losses.[644]

License holders are eligible for **3-year tax holidays** commencing from the certified date of mining operation which may be extended for an **additional 2-year period** if the Minister for Mines and Steel Development is satisfied as to the rate of expansion, standard of efficiency, level of development of mining operations, and the implementation of any conditions including the training and development of Nigerian personnel.[645] All operators may enjoy **exemption from customs and import duties** for approved plant, machinery, equipment and accessories specifically and exclusively imported for mining operations. Income tax incentives targeted at FDI include a quota for **tax-free personal remittances for expatriate personnel** coupled with foreign exchange rules permitting the transfer of external currency out of Nigeria.[646] As most prime mining locations are found in underdeveloped and often inaccessible regions, investors may be able to claim additional **rural investment allowances**[647] resulting in **enhanced or multiple deductions** for qualifying capex.

The Ministry of Mines and Steel Development has marketed investment opportunities at international mining events. Mining interests hitherto held by the Nigerian Mining Corporation were to be privatised to local and international investors in an on-going bidding process. Recent privatisation exercises have involved bids for bitumen and coal fields from 60 local and foreign investors.[648] Emerging economies like China have indicated interest in

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643 15% first year initial allowances followed by 10% annual allowances: ¶5 of and Tables I & II to the Second Schedule to CITA 1979.

644 Eligible losses are capped at values equivalent to the capital allowances claimed in the year of assessment from which the losses were brought forward.

645 §28 NMMA 2007.

646 §25 NMMA 2007.

647 This applies for capex for electricity, water, roads, telecommunications located in rural, underdeveloped areas and ranges from 5% to 100% on capex depending on the infrastructure provided: §34 CITA 1979. However, these rural investment allowances operate in exclusion to pioneer period tax holidays: §40(12) CITA 1979.

648 See 'FG Pre-qualifies 60 Firms on Mining Assets Bidding', *This Day* newspaper report by Onyebuchi Ezigbo], 5th February, 2006 <http://www.thisdayonline.com/nview.php?id=47077> accessed 02.05.06.

investing substantially in the sector. [649] However, investors have been discouraged by the recent 'revalidation exercise' by the new Minister of Mines and Steel Development (Chief Sarafa Ishola) of existing mining licenses awarded by the mining cadastral office.[650]

The majority of mining activities are carried out illegally by the largely unregulated informal sector. A notable feature of the present regulatory regime is the emphasis on technical support for small-scale miners and micro-entrepreneurs. [651] **§3.2.8** examines the scope of tax incentives specifically targeted at promoting sustainable economic development in the services sector in which the large informal sector is also very active.

3.2.8. OTHER SERVICES

3.2.8.0. Overview

Globally, the service sector is increasing its significance with the composition of world-wide FDI leaning towards services. The migration of export-oriented services offshore has lead to numerous challenges and opportunities for both developed and developing nations.[652] On a domestic level, NEEDS expects the growth in services to boost the economic performance of the real sector.[653]

3.2.8.1. Information & Technology

Current economic policy considers the development of the information and technology sector as crucial to national development and competitiveness. NEEDS seeks to address the challenges posed by the dearth of local software development capacity, the poor telecommunications and postal service and inadequate investment in human capital, technological know-how and science-

649 'China Rationalises $15bn Investment in Nigeria', *This Day* newspaper report by Onyebuchi Ezigbo], 5th January, 2006 accessed at <http://www.thisdayonline.com/nview.php?id=46991> on 02.05.06.

650 Yet another example of Nigerian policy uncertainty: 'Govt okays mining policy', *Nigerian Guardian Newspapers* article, 21 February 2008 accessed at <http://www.guardiannewsngr.com/news/article03> on 21.02.08.

651 §§34 & 91, NMMA 2007.

652 UNCTAD, *World Investment Report 2004*, chapters III and IV.

based skills. Key policy points focus on promoting telecommunications by establishing a national multimedia super-corridor, establishing specialised science and technology parks and technology incubation centres in various parts of the country, enhancing intellectual property rights and upgrading local capacity to produce hardware and software inputs.[654]

NEEDS proposes to provide both financial and **fiscal incentives** to facilitate the development of a multimedia super-corridor and also to provide incentives to promote the development of industrial parks and telecommunications technology.[655] Existing fiscal incentives include the **deductibility of R&D expenses** from taxable profits subject to a ceiling of 10% of the relevant company's total assessable profits. Companies and organisations which specialise in the commercial application of R&D may claim a **20% investment tax credit** on relevant R&D expenditures.[656] Alternatively, generous **initial allowances** may be claimed to write off R&D expenses.[657]

The special incentives provided by VC Act 1993 are also relevant. Eligible projects include those facilitating industrialisation by the use of innovative ideas, projects and techniques; those utilising commercial applications of research findings; and those encouraging indigenous processes and technologies. Applicable tax incentives include: **capital allowances** for the **cost of equity investments** in eligible venture capital companies applied on a 30:30:20:10:10 basis to write off the investments against the investor's taxable income over 5 years;[658] **capital gains tax exemptions** on disposals of equity and **withholding tax reductions** on dividends paid.[659] In addition, there are

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653 NEEDS Report, Chapter 6: Sectoral Strategies, p.72.
654 *Ibid*, pp.57,73.
655 NEEDS Report, Chapter 6: Sectoral Strategies, p.73.
656 §26 CITA 1979.
657 An initial allowance of 95% on qualifying expenditure on a wide range of R&D outlays (equipment and facilities, patents, licences, secret formulas or processes, industrial, commercial or scientific information, technical feasibility studies) may be deducted in computing taxable profits: ¶(1)(1)(f) of; and Tables I & II to the Second Schedule, CITA 1979.
658 §4 VC Act 1993.
659 §4(c) & (d) VC Act 1993.

pioneer tax holidays and other incentives under the ID/ITR Act 1971 for the manufacture of computers, installation of scientific instruments and communication equipment, and production of ICT equipment including hardware and software;[660] and **export-promotion incentives** under the *Export (Incentives and Miscellaneous Provisions) Act No. 18 of 1986.*[661]

3.2.8.2. **Tourism, Real Estate Development, Film & Entertainment**

Despite the potential for large revenues, **tourism** in Nigeria is an untapped, underdeveloped sector. The infrastructure of game reserves, natural springs, tourist resorts and other facilities have declined over the years. For instance, the 800miles^2 Yankari National Park is the largest of seven-odd game reserves but has lost many of its 50 endangered wildlife species to poachers and deforestation. The Jos Plateau – which was once the centre of local tourism due to its temperate weather, rare crater lakes, scenic Shere Hills and picturesque Aesop Falls – has been adversely affected by violent ethnic and religious conflicts, poor security and corruption. NEEDS proposes to promote private sector and foreign investment in tourism by concessioning existing tourism attractions and implementing polices which favour tourists, investors and the environment.[662]

A recent development which may change the fortunes of this sector is the Cross River State Government's **Tinapa Business Resort** located at Adiabo on the Calabar River near the Calabar Free Trade Zone. The N45billion (US$350million) Tinapa Business Resort is to be a world-class holiday and shopping resort comprising: warehousing facilities; wholesale and retail trading emporiums and shopping outlets; budget and luxury hotels; cinemas, casinos and restaurants; water-world parks and other leisure facilities. The Cross River State government hopes to build on the significant success of its other tourism

660 Items #37, 43 and 66 on the List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

661 §4(e) & (f) VC Act 1993.

662 NEEDS Report, Chapter 6: Sectoral Strategies, pp.73-74.

project, **Obudu Ranch Resort**, which is the leading tourism resort in Nigeria.[663]

Promotional material indicates that Tinapa Business Resort possesses a free trade status; incentives identical to those available in EPZs are to be extended to investors in the Resort.[664] Although the precise enabling legal regime for these incentives is opaque,[665] this Researcher was able to determine that Tinapa Business Resort was granted EPZ status under §1(1) NEPZ Act 1992 by Presidential approval.[666] Tinapa Business Resort Free Zone Enterprise was established as a subsidiary entity to manage the zone in accordance with §1(2) NEPZ Act 1992. As such, Tinapa free trade zone is legally as well as geographically distinct from the contiguous Calabar free trade zone. Investors in Tinapa would consequently enjoy income tax exemptions and other EPZ incentives.

These EPZ incentives would be in addition to existing but more modest tax incentives for investors in hotels and other resorts. CITA 1979 provides that **25% of tourism revenues** received in foreign exchange is **tax exempt** provided kept in a special reserve fund and utilised within 5 years in the expansion of new tourism facilities.[667] Similarly, NIPC's extended list of pioneer industries (and the related **5-year tax holidays and other incentives**) includes tourism by way of the development of holiday resorts, hotels, sporting and recreational facilities.[668]

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[663] Broll Retail Projects and Tinapa Business Resort Limited; 'Tinapa Business Resort Limited: Africa's Most Exciting Leasing Opportunity' Brochure <http://www.tinapa.com/html/downloads/downlaod.html> and <http://www.tinapa.com> both accessed 30.03.07.

[664] Tinapa Press Release 1-'Free Trade Zone' issued by the Gendel Group for Tinapa Business Resort (2004) <http://www.tinapa.com/images/media/press_01.pdf> accessed 30.03.07.

[665] This Researcher frequently encountered instances whereby the underlying legislative authority for certain incentives was either opaque or obscure. See **§7.4.2** below.

[666] Statements by Eyo Ekpo, (former) Attorney-General Cross Rivers State, Nigeria and Orok B. Okon, Personal Assistant to the Attorney-General (personal communication 5 April, 2007).

[667] §37 CITA 1979.

[668] Item #67, List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, *op cit*, Chapter 1: General Incentives, pp.2-6.

Another sub-sector which features on NIPC's extended list is **real estate development**. This category includes projects earning rental income from residential and commercial premises and capital gains from interests in real estate disposed within a specified period.[669] As noted earlier, the legal position of NIPC's extended list is unclear. However, the promotion of real property development is consistent with the policies outlined by NEEDS to promote infrastructural development.

NEEDS also seeks to promote the **indigenous entertainment industry**, focusing on the burgeoning film industry located in Eastern Nigeria. Key issues include improving the technical inputs and quality of films, developing the export market and providing access to finance to investors. Incentives are to be provided to increase private sector participation in the sector but it is unclear if these include tax incentives.[670]

3.2.8.3. Education, Government Services & Public Corporations

Certain profits of non-for profit, statutory or public owned corporations are **exempt from corporation income tax** under CITA 1979. The provisions cover income accruing to statutory or registered friendly societies; ecclesiastical, charitable or educational companies; corporations to promote sporting activities; commodity purchasing authorities; and state development corporations.[671] Local government councils, purchasing authorities and state development corporations are **exempt from capital gains tax**.[672] Financing by various public bodies and governments may attract tax incentives such as the **withholding tax exemption** for interest accruing to investors in Lagos State

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669 Item #68, *ibid.*

670 NEEDS Report, Chapter 6: Sectoral Strategies, pp.74-75.

671 §23 CITA 1979. Public corporations such as the Odu'a group of companies and the New Nigeria Corporation rose to prominence during the 1970s and 1980s. However, under NEEDS the private sector is the preferred engine for economic growth and development and it is probable that there will be a decline in tax and other incentives provided to support public corporations.

672 E.g. for local governments: §27 CGTA 1967.

Government's Redeemable Bond Issue 2005/2009.[673] Charitable donations made to benefit approved public funds, statutory corporations and ecclesiastical, benevolent, educational and scientific institutions are also treated as tax deductible expenses.[674] Nigerian tax law goes further in the promotion of education by imposing a special **education tax** levy which is charged on all companies at 2% of their assessable profits. The education tax is collected by FIRS and paid into an Education Fund which disburses the funds to federal, state and local government educational institutions.[675] However, under proposed legislation this levy is to be eliminated and replaced with an appropriation charge from the Consolidated Revenue Fund.[676]

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673 Under the *Companies Income Tax (Second Lagos Government Redeemable Bond) (Exemption Order) S.I. No. 16 of 2003.*

674 §25 CGTA 1967.

675 §§3-5 ETA 1993.

676 A Bill for an Act to amend the Education Tax Act, Nine Draft Bills on Tax Reforms, *op cit*, pp.91-94.

3.3. CONCLUSION

This Chapter traces the historical and political evolution of the Nigerian legal system as the background to the development of the current system of taxation. It summarises key characteristics of the Nigerian tax system noting the division of taxing powers between the federal, state and local governments, and highlighting salient aspects of tax administration and dispute resolution. It sets out the political framework for tax incentives, selective interventions and other aspects of economic policy underscoring the central role of NEEDS in current policy initiatives. However, its main purpose has been to present a detailed exposition of existing tax incentives for selected economic sectors including: agriculture, energy, financial services, infrastructure, basic services, the formal industrial sector, SMEs, mining and other sectors like technology, tourism, real estate development, entertainment and education.

Diverse kinds of tax incentives have been used to encourage economic growth and development and the precise mix of tax incentives has varied over the years with changing economic policies. Blunt import-substitution and industrial-oriented incentives have slowly given way to more selective export-oriented incentives. While the legal bases for most of these measures have been identified in this Chapter, some provisions remain obscure. The influences of international tax, trade and finance have been deliberately been excluded. These issues shall be examined in Chapter 6. Chapter 7 completes the mosaic with a critical analysis of the role of tax incentive policy in promoting sustainable economic development in Nigeria using exemplars from the other study countries. Chapters 4 and 5 will review South African and Kenyan tax incentive practices adopting the sectoral approach used in this Chapter.

4. A REVIEW OF SOUTH AFRICAN TAX INCENTIVES

"After climbing a great hill,
one only finds that there are may more hills to climb...
I can rest for only a moment, for with freedom comes responsibilities,
and I dare not linger, for my long walk is not yet ended."[677]

4.0. INTRODUCTION

4.0.1. Proem

This Chapter reviews the Republic of South Africa's tax and investment incentives policy set against the historical, political, economic and legal background. It adopts the sectoral approach used in Chapter 3 to highlight South African tax incentives utilised to promote employment, economic growth and development. Information obtained by bibliographical research is complemented by perceptions gleaned from interviews of leading South African tax academics, accountants, lawyers and professionals conducted during a South African Field Trip in May 2007. Views were also obtained from the Chief Director of Tax Policy/Head of the Tax Unit of the South African National Treasury and a South African Revenue Service official. Exemplars based on the tax and investment incentives considered here are critically considered in Chapter 7 providing some useful lessons for the reform of tax incentive policy in Nigeria.

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677 Nobel Peace Prize Laureate Nelson Mandela, *The Long Walk to Freedom: Autobiography of Nelson Mandela*, p.554 (Brown & Co, Little: 1994).

4.0.2. Historical Development of the South African Legal System[678]

4.0.2.1. Early Legal Development

South Africa was originally inhabited by the indigenous Khoikhoi (the Hottentots) and San (the Bushmen) people, with the influx of the majority Bantu-speaking groups and the Nguni (forebears of the Zulu and Xhosa peoples) occurring by 100 A.D. and 500 A.D. respectively. The rise of the Zulu kingdom under Shaka in the 1820s brought numerous smaller groups under the control of a centralised nation-state. The cultural practices of these indigenous peoples are preserved in contemporary customary law, which recognised as a distinct source of law under the Constitution of the Republic of South Africa, Act 108 of 1996 (hereafter: CRSA 1996).[679]

However, the formal origins of what has become the South African legal system may be traced to the founding in 1652 of the Dutch East India Company's settlement at the Cape of Good Hope. Roman-Dutch law was transplanted from Holland and applied by the Dutch East India Company (hereafter: VOC), initially only to Dutch citizens then eventually to all residents of the territories under VOC's control. However, it was not until the Dutch[680] and (subsequently) the British[681] governments took over the direct administration of the colony that there was a clear separation of judicial and administrative/executive functions. British jurists and legal practitioners introduced new legislation and English common law concepts and procedure into the matrix of Roman-Dutch law. The commercial undertones of received English law also gave impetus to wider social, political and commercial reforms coinciding with the reduction of VOC's powers and liberalisation of international trade.

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678 See generally Prof. François du Bois' account of the historical development of the South African legal system: François du Bois, Chapter 1: 'Introduction: History, System and Sources,' in C.G. Van de Merwe and Jacques E. du Pleiss (eds) *Introduction to the Law of South Africa*, (Kluwer Law International, The Hague: 2004), pp.1-53.

679 §211 CRSA 1996.

680 In 1803.

4.0.2.2. Anglo-Boer Conflict & the Union of South Africa

Roman-Dutch law was allowed to flourish in independent Boer republics established by Boer Voortrekkers migrating inland into Zulu territory to avoid British colonial rule. Unlike the Republic of Natalia, the South African Republic (Transvaal) and the Orange Free State were permitted some autonomy and adopted a Presidential system of governance that preferred the separation of powers and constitutional supremacy to parliamentary supremacy under the Westminster model.[682]

The 1871 discovery of diamonds in Kimberley and post-1886 conflicts over rights to exploitation of gold deposits in Transvaal's Witwatersrand region led to the Anglo-Boer (or South African) Wars waged between 1899 and 1902. The Boers were ultimately defeated by the British. The two Boer republics were subsequently united on 31 May 1910 with the British colonies of Natal and the Cape to form the Union of South Africa under the Treaty of Vereeniging. Parliamentary sovereignty was restored under the Union Constitution with a Parliament comprising Lower and Upper Houses.

4.0.2.3. The Republic of South Africa & *Apartheid*[683]

Non-Whites were denied franchise under the new political dispensation with the few Black, Indian and Coloured voters being systematically removed from the common voters' roll. Racial segregation continued with land reform, new pass laws and influx controls, and limited opportunities for education, employment and public services for non-Whites.[684] A section of the Afrikaner National Party came to power in 1948 and introduced the *apartheid* system which ultimately culminated in political separation of 'independent' States for

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681 British control of the Cape colony acquired by military conquest in 1806 became permanent in 1815.

682 Johan de Waal, Chapter 2: 'Constitutional Law,' in *Introduction to the Law of South Africa*, *op cit*, p.56.

683 See generally 'South Africa: Recent History' by Christopher Saunders, in *Africa South of the Sahara* (34th Edition, Europa Publications/Taylor & Francis Group, London: 2005) pp.1044-1053.

684 Johan de Waal, Chapter 2: 'Constitutional Law,' in *Introduction to the Law of South Africa*, *op cit*, p.58.

Black Africans from the Republic.[685] Resistance to *apartheid* led to political opposition, mass civil disobedience and armed resistance by the South African Communist Party (SACP), the African National Party (ANC), the South African Indian Congress and the Pan-Africanist Congress particularly in response to the 1960 Sharpeville massacre. African leaders were arrested and convicted of treason; *apartheid* was consolidated; and political repression became more brutal despite widespread international indignation and sanctions.[686]

South Africa became a Republic in 1960 and left the Commonwealth. Minor reforms were implemented by the ruling National Party's leader P.W. Botha in response to the deteriorating political situation and growing international opposition to *apartheid*. However, it was only under leadership of F.W. de Klerk did the growing disillusion among Afrikaner intellectuals, professionals and the business community with *apartheid* crystallise into political and social reform.

4.0.2.4. The Post-*Apartheid* Democratic Era

De Klerk released Mandela from in 1990 and removed bans on previously proscribed political parties. Desegregation occurred in all facets of society and international sanctions were lifted. A series of constitutional negotiations lead to the adoption of a new 'interim' Constitution in 1993.[687] The 'independent' native homelands were absorbed into the Republic and the existing provinces were reorganised into 9 regions.[688]

The ANC won the first democratic elections held on the 24 April 1994 and formed a government of national unity with the Inkatha Freedom Party. Mandela was elected as President with Thabo Mbeki and de Klerk serving as

[685] The 'independent' States were Transkei, Bophuthatswana, Venda, Ciskei, Lebowa, Gazankulu, Qwaqwa and KwaZulu.

[686] International sanctions imposed from 1967 continued till 1994.

[687] *Constitution of the Republic of South Africa, Act 200 of 1993.*

[688] Namely the Western Cape, Eastern Cape, Northern Cape, Orange Free State (or Free State), North-West, Natal (or KwaZulu/Natal), Eastern Transvaal (or Mpumalanga), Northern Transvaal (or Limpopo) and Gauteng (Pretoria, Witwatersrand and Vereeniging) Provinces.

Deputy Presidents. A Constitutional Assembly concluded negotiations in 1996 which led to the adoption of a new 'final' Constitution (hereafter: CRSA 1996) on 4 February 1997. President Mandela resigned in December 1997 and was replaced by Thabo Mbeki with Jacob Zuma acting as Deputy President. Mbeki and Zuma led the ANC to electoral victory in the general elections of June 1999 and April 2004. Despite corruption charges and other political scandals, Zuma seems likely to succeed Mbeki in the 2009 general elections.[689]

4.0.2.5. The Constitution & Economic Rights

Certain socio-economic rights are guaranteed under CRSA 1996. These include the right to housing, health care, food and water, and social security. South African jurisprudence [690] indicates that these rights may be judicially enforceable by negative [691] and possibly positive means [692] although this interpretation is not without controversy.[693] CRSA 1996 also provides for freedom of choice in the pursuit of a trade, occupation and profession, and permits these economic activities to be regulated by the State.[694]

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689 'Zuma victory leaves ANC divided,' BBC website report by Peter Greste, BBC Polokwane, 18th December 2007 <http://news.bbc.co.uk/2/hi/africa/7151108.stm> accessed 04.02.08.

690 Johan de Waal, Chapter 2: 'Constitutional Law,' in *Introduction to the Law of South Africa*, *op cit*, pp.99-100.

691 That is, by preventing the State from effecting policies which deny citizens access to adequate housing and social amenities: *Government of the Republic of South Africa v. Grootboom* 2000 (11) BCLR 1169 (CC) at ¶88.

692 Requiring the State to proactively implement measures which enforce the social rights of citizens: see *Minister of Health v. Treatment Action Campaign 2002* (5) SA 721 (CC) compelling the State to make available a certain drug at no cost to HIV-positive mothers and their children.

693 Cf. *Soobramoney v. Minister of Health, KwaZulu-Natal* 1998 (SA) 765 (CC).

694 §22 CRSA 1996.

4.1. THE SOUTH AFRICAN TAX SYSTEM

4.1.0. Historical Development of Taxation in South Africa

Prior to the creation of the Union of South Africa, the provinces (Cape Colony, Natal, Orange River Colony and Transvaal) exercised fiscal autonomy.[695] Revenues accrued mainly from railway receipts and custom duties. Significant taxes were the (successful) direct tax of 5% (later 10%) on gold mining profits[696] and the (unsuccessful) general income taxes imposed by the Cape Colony and Natal governments in 1904 and 1908 respectively.[697] Income tax was successfully reintroduced in the *Income Tax Act of 1914* and, fuelled by political pressures to increase distribution of wealth by tax transfers, progressive taxes, surtaxes and excess profits taxes on top income earners were introduced.[698] The introduction of new investment tax allowances for corporate investors reduced the tax base between 1975 and 1990 but a new general sales tax was used to broaden the tax base.[699] With the abolition of *apartheid* and the introduction of democratic rule, the attraction of vital investment lost during the *apartheid* period became a significant economic objective.

4.1.1. Investing In South Africa

Local and foreign investment is actively encouraged by numerous policies including both tax and non-tax incentives. The Department of Trade and Industry (hereafter: DTI) lies at the heart of these initiatives, providing a variety of services to intending and existing investors. Liberal exchange control policies have removed most restrictions on FDI other than restrictions on the amount of debt financing foreign investors may raise on local money markets.[700] Foreign investors may freely raise equity from local capital markets

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695 Lieberman, *Race and Regionalism in the Politics of Taxation in Brazil and South Africa, op cit*, pp.108-109.

696 Introduced first by Transvaal in 1898 and used to finance the Boers' war expenditures.

697 Lieberman, *Race and Regionalism in the Politics of Taxation in Brazil and South Africa, op cit*, p.111.

698 *Ibid*, pp.125-127;128-129.

699 *Ibid*, p.168.

700 Foreign (non-resident) investors are precluded from procuring local financial assistance in the form of loans and credit facilities. The regulations cover various forms of credit facilities subject to certain exceptions but also permit greater access

and stock exchanges but require approval by the South African Reserve Bank's Exchange Control Department to make offshore loans to resident entities.[701] Foreign investors may repatriate profits, dividends, interest, rentals, royalties,[702] management and administration fees, and other receipts subject to certain restrictions. Certain transactions require Exchange Control approval while others may be approved by authorised dealers in foreign exchange.

South Africa belongs to both the Southern African Customs Union (SACU) and Southern African Development Community (SADC). SACU includes neighbouring Botswana, Lesotho, Namibia and Swaziland and permits the free-flow of goods and services between member countries. SADC is a wider community of 14 Southern African countries[703] forging greater economic ties within an increasingly expanding free trade zone.

Numerous **forms of business organisation** are available to local and foreign investors. Investors may transact business individually as sole traders, combine through partnerships,[704] joint ventures and syndicates or operate through trusts. However, corporate forms of organisation (companies and close corporations) are most commonly utilised.[705] Where foreign corporations establish a 'place of business' within South Africa, they are required to incorporate their undertakings as an external company under the *Companies Act 61 of 1973*.[706] Normal companies may have the liability of members limited by shares,[707] or by guarantee, although most companies formed to pursue commercial activity for profit invariably have share capital. Companies formed

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to local credit facilities where there is increased participation by local investors in the subsidiary: Mark Badenhorst and Elizabeth de Brauw, Jude Amos and Angela Seyfang (eds.) *Taxation & Investment in South Africa* (IBFD, Amsterdam: 2003), ¶4.4.4.

701 *Ibid*, ¶4.4.5.

702 Royalties are subject to withholding taxes at 12% subject to the availability of treaty relief: *ibid* ¶4.5.3.

703 Including Angola, Botswana, the DRC, Lesotho, Malawi, Mauritius, Mozambique, Namibia, the Seychelles, Swaziland, Tanzania, Zambia and Zimbabwe.

704 These are regulated by common law and may consist of no more than 20 partners: §30(1) *Companies Act 61 of 1973*.

705 Philip Sutherland, Chapter 10: 'Companies and Other Business Entities,' in *Introduction to the Law of South Africa*, *op cit*, pp.365-398.

706 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, chapter 6.

by certain professionals[708] may have unlimited liability to ensure compliance with the nature of their professions.[709]

Companies may be public or private, with the main distinction being the number of shareholders permissible.[710] Close corporations are special corporate entities formed in terms of the *Close Corporations Act 69 of 1984* which permits the incorporation of smaller businesses. The main advantages associated with close corporations are the fewer formalities and expenses involved in incorporation, management and compliance with accounting[711] and other regulatory requirements.[712]

4.1.2. Taxing Powers, Tax Administration & Dispute Resolution

Taxing powers are shared between the central, provincial and local governments. The central government levies, collects and administers the main types of taxes and remits a portion of collected revenues to the provinces. Under the CRSA 1996, the provinces are empowered to levy certain taxes, levies, user and service charges.[713] Provinces are allocated an equitable share of centrally collected income taxes on individuals, national fuel levies and VAT based on the recommendations of the Financial and Fiscal Commission.[714] Provinces benefit from transfer tax revenues[715] and grants from the central government. Provinces, in turn, allocate funds to local governments based on

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707 Shares may have a certain par value or indeed may have no par value.

708 E.g. attorneys, auditors and medical practitioners.

709 §53(b) *Companies Act 61 of 1973.*

710 Private companies may have a single member but must have no more than 50 members (as they are required to restrict the right to transfer shares and the public offer of securities). Conversely, public companies are under no such restrictions and must have at least 7 members.

711 §56 *Close Corporations Act 69 of 1984* cf. §61 *Companies Act of 1973.*

712 Badenhorst, *Taxation & Investment in South Africa, op cit,* ¶5.3; Philip Sutherland, Chapter 10: 'Companies and Other Business Entities', in *Introduction to the Law of South Africa, op cit,* pp.390-392.

713 Such as taxes on casinos, gambling and lotteries. However, provinces may not levy income tax, VAT or sales tax.

714 The Financial and Fiscal Commission advises Parliament on financial and fiscal policies and the allocation of financial/fiscal resources among the various levels of government.

715 A province's share of transfer tax revenues is that relating to property situate in that province.

criteria determined by the Financial and Fiscal Commission. The local governments have limited taxing power and they may levy only certain property taxes and user charges. However, local governments are assuming competence to impose regional establishment levies and regional service levies.[716]

Taxes administered by the central government include the income or normal tax in terms of the *Income Tax Act 58 of 1962* (hereafter: ITA 1962), value added tax under the *Value Added Tax Act, 1991* (hereafter: VAT Act 1991), transfer duty on the alienation of real estate,[717] stamp duties tax,[718] taxes on marketable and dematerialised securities, [719] fuel levies and certain other taxes. [720] However, recent fiscal proposals replace stamp duties and uncertificated securities tax on secondary trades with a single securities tax[721] and abolish tax on retirement funds.[722] Central taxes are generally administered by the South African Revenue Service (hereafter: SARS) which was formed by the merger of the Inland Revenue and the Customs and Excise units of the Department of Finance.[723] SARS is headed by a Chief Executive Officer but the Commissioner for SARS[724] has general responsibility for tax administration. The Commissioner operates out of SARS's Pretoria headquarters.

The primary sources of tax revenues are the income tax and VAT.[725] **Income or normal tax** is administered under the ITA 1962 and is levied[726] on **taxable income**[727] attributable to individuals, corporate entities (companies and close

716 Badenhorst, *Taxation & Investment in South Africa, op cit*, chapter 20.
717 Under the *Transfer Duty Act.*
718 Under the *Stamp Duties Act.*
719 Under the *Marketable Securities Act* and the *Uncertificated Securities Tax Act* respectively.
720 See for instance, taxes imposed under the *Tax on Retirement Funds Act.*
721 SARS, Budget Tax Proposals 2007/8, p.17.
722 *Ibid*, p.24.
723 On 18 October 1995 with operations commencing on 1 April 1996.
724 §2(1) ITA 1962.
725 VAT is levied at the rate of 14% on the supply of goods and services by a vendor, the importation of goods into South Africa and the supply of imported services by a non-resident to a resident person: VAT Act 1991; Badenhorst, *Taxation & Investment in South Africa, op cit*, Chapter 21.
726 By §5 of ITA 1962.
727 Generally, taxable income is calculated by adding certain sources of income (inclusive of 'deemed income') to 'gross income' and deducting certain exempt

corporations) and other taxable entities (trusts and estates). Taxable income is a wholly artificial concept that does not purport to correspond to accounting or economic income,[728] but is the residue of 'income' as defined in terms of §1, ITA 1962 after the application of rules on permissible deductions. Two main deduction rules apply under the **general deduction formula**: the 'positive' test for deductible expenditure under §11(a) ITA 1962; and the 'negative' test for of disallowed expenditure under §23(g).[729]

De Koker concisely posits that these dual provisions combine to stipulate the following rule: '... expenditure and losses must be actually incurred during the year of assessment in the production of income: they must not constitute expenditure or losses of a capital nature, and if they are claimed as a deduction against income derived from the trade, they must, either in part or in full, constitute moneys that are laid out or expended for the purposes of trade.'[730] While some tax incentives are provided by this general deduction formula, many of the incentives considered later in this Chapter come within special provisions.

The rates at which normal tax applies vary. Companies[731] are generally taxed at 29% on taxable income (28% with effect from the 2008 fiscal year)[732] and an additional 12.5% secondary tax on companies (hereafter: STC) applied on the

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income to arrive at 'income'; such 'income' is adjusted for deductions and allowances and aggregated with taxable capital gains to arrive at 'taxable income'. Notably, in computing gross income, the value of opening stock/inventory is added to other sources of income and that of closing stock/inventory is deducted: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶¶9.4.1 and 10.5.4.

728 *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 389; *Pyott v CIR* 1945 AD 128, 13 SATC 121 T 126-7. See further, Alwyn de Koker, *Silke on South African Income Tax*, (1995 Memorial edition, 2005 Service 31, LexisNexis Butterworth, Durban, 2005), §7.1.

729 §§11-19, and §23 ITA 1962 respectively for corresponding positive and negative lists of deductible expenditure.

730 *Silke on South African Income Tax*, *op cit*, §13.2 at p.7-9.

731 The term 'company' is defined by §5 ITA 1962 and includes associations, corporations and companies incorporated under South African law or the laws of other jurisdictions as well as South African close corporations: *Silke on South African Income Tax*, *op cit*, §13.2.

732 Budget Review 2008, pp.56,61.

net amount of dividends declared and distributed.[733] However, STC is will soon be replaced with a lower rate (10%), broader-based dividend withholding tax.[734] Generally, trusts are charged on taxable income in similar fashion to other taxable persons.[735] For persons other than companies and trusts (i.e. natural persons), tax is levied based on graduated progressive rates with the highest tax bracket of R490,000+ being taxed at a marginal rate of 40%.[736] Shares of profit remitted to non-resident partners are not subject to withholding taxes. However, normal tax of between 30% and 35% may apply on partnership profits (and certain foreign investment income) prior to distribution.[737] Remittances to foreign investors with interests in syndicates are also exempt from withholding taxes. Royalties of external companies deemed to be derived from a South African source are taxed at 30% while royalties and other payments attributable to the use of intellectual property accruing to non-residents are subject to withholding taxes at 12%.[738] Donations tax is levied at 20% on certain disposals of property.[739] However, donations by public corporations are exempt resulting in a major difference in tax treatment between public and private companies.[740]

South Africa has replaced the traditional source basis of tax with a **residence basis**.[741] Consequently, while South African residents are currently taxed on their worldwide income, non-residents are liable to tax only on income derived from a South African source.[742] Certain rules determine residence for

733 STC is applied on the net surplus of dividends declared over dividends received during the relevant dividend cycle: §64B and §64C, ITA 1962; *Silke on South African Income Tax*, *op cit*, §13.10.

734 SARS, Budget Tax Proposals 2007/8, p.24; Budget Review 2008, pp.56,61.

735 According to progressive rates in special tables; although there are some differences between the tax treatment of special and other trusts: see further *Silke on South African Income Tax*, *op cit*, §12.14.

736 For fiscal year 2007/08: Table 4.7, Budget Review 2008, p.65.

737 The higher band applies where the non-resident partner is a corporate entity managed outside South Africa: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶7.3.

738 Subject, however, to the terms of any applicable double taxation agreements.

739 §64 and Part V, ITA 1962.

740 §56(1)(n) and §38, ITA 1962; *Silke on South African Income Tax*, *op cit*, §23.2.

741 Announced in the SA Budget Speech 2000/2001 with effect from 1 January 2001.

742 See generally Lynette Olivier and Michael Honiball, *International Tax: a South African Perspective* (3rd ed., Cape Town, Siber Ink: 2005) chapter 3.

individuals and corporations.[743] Non-resident recipients of interest income pay no withholding tax on such receipts although income tax liability may arise if paid from South African sources.[744] Worldwide capital receipts accruing to residents from the actual or deemed disposal of capital assets are liable to tax at 25% for individuals and at 50% for legal entities.[745] Non-residents may be liable to **capital gains tax** only where a capital gains tax event occurs relating to rights to or interests in immovable property situate in South Africa or assets owned by the South African permanent establishment of the non-resident.[746]

External companies established by foreign corporations to incorporate local places of business are liable to normal tax at the rate of 30% on taxable income in addition to STC at 12.5% on distributed profits. Unincorporated branches of foreign corporations are not legally distinct entities but are treated as such for tax purposes. The taxable incomes of these branches are taxed at 34% – a higher rate than external companies as neither withholding taxes nor STC are levied on remitted branch profits.[747]

Double taxation relief may be provided unilaterally under the ITA 1962, under the terms of double taxation agreements or indeed, by general deduction of foreign taxes imposed on incomes liable to South African tax.[748] South

743 For individuals, the rule implies the most fixed and settled residence to which an individual normally returns from his travels. For companies, the concepts of place of management and control or place of effective management are used: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶12.3

744 Such liability may be limited by any relevant double taxation agreements. Generally, these limit the rate of tax to 10% of the gross amount of interest paid to a resident of the other contracting state though more recent treaties grant the right to tax to the country of residence (unless paid by a permanent establishment in South Africa): *ibid*, ¶18.3.5.

745 §26A and the Eighth Schedule to ITA 1962; *Silke on South African Income Tax*, *op cit*, chapter 24.

746 Capital gains tax was first introduced with effect from 1 October 2001: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, chapter 27.

747 Conversely, a South African resident would be liable to tax on income remittances from foreign branches though a credit may be given for any foreign tax suffered. However, where such remittances are sourced from certain designated countries (namely countries with tax systems similar to that of South Africa and tax rates of at least 27%), such remittances would be treated as exempt income: *ibid*, chapter 6.

748 Olivier and Honiball, *International Tax: a South African Perspective*, *op cit*, chapter 6.

Africa has an extensive network of double taxation agreements[749] including some which were recently ratified,[750] are yet to be ratified,[751] are unsigned and are under negotiation.[752] Generally, income attributable to permanent establishments of enterprises resident in contracting states are liable to South African tax on profits attributable to such permanent establishments. Similar provisions are contained in recent double taxation treaties as regards dividends, interest and royalties.[753]

Certain procedures and institutions expedite **dispute resolution** for tax matters. These procedures and institutions give effect to constitutional provisions[754] guaranteeing the right to administrative action that is lawful, reasonable and procedurally fair.[755] On notification of the obligation to file tax returns, taxable persons and entities submit their returns within the relevant time prescribed. The Commissioner and Receivers of Revenue assess taxpayers to tax by the issue of notice of assessments, additional assessments or estimated assessments. Such assessments are subject to taxpayers' rights of objection and appeal.[756] Appeals against tax assessments generally lie to Special Courts for Income Tax Appeals. These Special Courts are superior courts established under the ITA 1962[757] and are constituted by a presiding High Court Judge, an experienced accountant and a representative of the commercial or business world. The Special Courts are of subordinate jurisdiction to divisions of the High Court,[758] High Courts of Appeal, the Supreme Court of

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749 With major trading partners like the USA (1st), Germany (2nd), UK (3rd), Japan (4th) and the Netherlands (5th): Pocket Guide to SA, Government Communications (GCIS) (STE Publishers, Pretoria: 2004), pp.56-58.

750 With the UK and Greece.

751 That with Nigeria has been ratified by South Africa but (as at 28.07.03) is yet to be ratified by Nigeria.

752 E.g. the DTA with Brazil.

753 Badenhorst, *Taxation & Investment in South Africa, op cit*, chapter 18.

754 §33 CRSA 1996.

755 Cara Hoexter, Chapter 3: 'Administrative Law,' in *Introduction to the Law of South Africa, op cit*, pp. 107-134.

756 §§81-88/Part III of Chapter III, ITA 1962; *Silke on South African Income Tax, op cit*, §§18.23-18.28.

757 Badenhorst, *Taxation & Investment in South Africa, op cit*, ¶9.2.2.

758 High Courts are superior courts of co-ordinate, geographically prescribed jurisdiction and are divided into 13-odd divisions. High Courts possess both original

Appeal[759] and the Constitutional Court.[760] Decisions of the Constitutional Court and the Supreme Court of Appeal are absolutely or fully binding on all other courts.[761] High Court decisions are either absolutely binding[762] on other High Courts and all inferior courts or of persuasive influence on other High Courts depending on the composition of the Bench determining the matter.[763] Special Courts for Income Tax Appeals are bound by decisions of the Constitutional Court, the Supreme Court of Appeal and High Courts but the Special Courts' decisions are of persuasive influence only on other courts.[764]

4.1.3. **Political Framework for Economic and Tax Policy**

Much of the responsibility for economic, monetary and tax policy rests on the shoulders of the current Minister of Finance, **Trevor Manuel**. Besides cabinet ministers and legislative committees, certain parastatals and public departments are involved in economic policy making. These include the Financial and Fiscal Commission, the South African Reserve Bank, the National Treasury and SARS. Private sector participation and input is also actively engaged. Current economic policy is based on the **Growth, Employment and Redistribution** strategy (hereafter: GEAR) introduced by Trevor Manuel in June 1996. Key aspects of GEAR are focussed on achieving annual economic growth of 6%,

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jurisdiction and appellate jurisdiction over appeals from the Special Courts for Income Tax Appeals, Magistrate Courts and other inferior courts: §168 CRSA 1996.

759 The Supreme Court of Appeal as the successor to the former Appellate Division of the Supreme Court is the highest court in South Africa as regards non-constitutional matters with unlimited appellate jurisdictions except where this specifically excluded: §168 CRSA 1996.

760 The Constitutional Court is the highest court in South Africa *vis-à-vis* constitutional matters being vested with appellate and judicial review powers (including the power to render null and void Acts of Parliament or provincial legislatures as being unconstitutional): §167 CRSA 1996.

761 Decisions of the Constitutional Court are binding on itself (until overruled) and absolutely binding on the Supreme Court. The Supreme Court is presumptively bound by its own decisions but may depart from them if subsequently held to be clearly wrong: see *National Media Ltd v. Bogoshi* 1998 (4) SA 1196 (SCA); *Amod v. Multilateral Motor Accidents Fund* 1999 (4) SA 1319 (SCA); François du Bois, Chapter 1: 'Introduction: History, System and Sources,' in *Introduction to the Law of South Africa*, *op cit*, pp.43-47.

762 When the decision is that of a full Bench, this is fully binding on single Bench High Court Judges and all Magistrates.

763 François du Bois, Chapter 1: 'Introduction: History, System and Sources,' in *Introduction to the Law of South Africa*, *op cit*.

764 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶9.2.2.

annually increasing job creation by providing 400,000 new jobs, promoting the redistribution of income to reduce income disparities and ensuring the provision of basic services for all South Africans.[765] GEAR provides tariff reduction to control input prices and tax incentives to encourage new investment. GEAR is complemented by a Medium Term Expenditure Framework (MTEF) and the *Public Finance Management Act* to promote better accountability.

Fiscal policy has focussed on inflation targeting, reducing the fiscal deficit and maintaining a stable government debt to GDP ratio. Tax compliance is exemplary and rising disposable incomes have given the government greater latitude in financing infrastructural projects, maintaining social spending (on health, education and transportation) and income redistribution under proposals for the MTEF highlighted in the 2008 Budget.[766] Recent fiscal policy has targeted the broadening the tax base by improving tax administration and taxpayer compliance; providing tax incentives for small business development,[767] R&D,[768] skills development and home ownership; and reducing the general tax burden by raising thresholds for specific types of taxation.[769]

The level of tax incentive support is controlled by prudent tax expenditure budgeting and other measures. Certain general rules apply to limit the quantum of capital allowances and other incentives enjoyed in any particular tax year to total taxable income or to taxable income from a particular source. The rest of this Chapter outlines sectoral tax incentives within the context of the economic realities of particular sectors.

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765 *Ibid*, ¶1.6.
766 Budget Review 2008, p.63.
767 See §**4.2.6** below.
768 See §**4.2.5.4** below.
769 Notably capital gains tax, estate duty, donations tax, transfer duty and stamp duties.

4.2. SECTORAL TAX INCENTIVES

4.2.0. Introduction

Early tax incentive policies were implemented under the import substitution industrialisation of the 1920s/1930s involving the use of high tariffs to protect and nurture indigenous 'infant' industries.[770] In the 1960s, incentives were used to implement *apartheid* influx control laws by reducing the movement of native Africans to the heavily industrialised 'white' cities. Tax and other[771] incentives were granted to industrialists relocating to less intensive industrial areas. However, not only were these incentives relatively expensive [772] but their rationales were questionable as the primary impact of these policies was the relocation and not creation of jobs.[773]

The use of grants, subsidies and other explicit forms of state assistance has increased in tandem with greater scrutiny of the costs of tax incentives. Blunt tax incentives such as tax holidays are being replaced with more targeted and cost-effective schemes. More recent tax incentives policies are considered below treated on a sectoral basis within the relevant economic and general taxation setting.

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770 Lieberman, *Race and Regionalism in the Politics of Taxation in Brazil and South Africa, op cit*, pp.112-113.

771 E.g. credit facilities, lower railway charges and reduced wage regulation.

772 Costing as much as R18,000 per job (at 1990 prices) with an aggregate cost of R18,000million between 1982 and 1990.

773 Linda van Buren 'South Africa: Economy', in *Africa South of the Sahara, op cit*, pp.1053.

4.2.1. AGRICULTURE & FOOD SECURITY

4.2.1.1. Overview

The importance of agriculture as a key economic sector is underscored by the fact that although it contributes a mere 4% to GDP,[774] it accounts for up to 10% of domestic employment.[775] Major crops include maize, sorghum and exported cash crops such as fruits, vegetables, cane sugar and wool. Livestock cultivation, forestry, fishing and wine production are also important sub-sectors. Agriculture possesses value-adding linkages with other economic sectors which has increased agro-industrial contribution to GDP to 15%.[776]

Recent crop production and exports[777] have been adversely affected by recurrent drought conditions and challenges with transportation infrastructure.[778] Although commercial agriculture is highly developed and productive, the large subsistence sub-sector is marked by underdevelopment and low productivity. Under the Integrated Food Security and Nutrition Programme targets were set to significantly improve national food security by 2015 and eliminate hunger and malnutrition. Further, the Strategic Plan for South African Agriculture seeks to increase production, competitiveness and African participation in the sector.[779] Tax incentive policy has also been used to promote agricultural production and output.

4.2.1.2. Agricultural Tax Incentives[780]

Agriculture has traditionally benefited from favourable tax policies featuring numerous tax incentives. Income from pastoral, agricultural or other farming operations is taxable subject to certain special provisions.[781] Special **tax averaging provisions** apply to income from farming and plantation activities,

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774 OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: South Africa*, p.462.
775 3% of GDP and 9% of employment as at 2004: Pocket Guide to SA, *op cit*, p.132.
776 Pocket Guide to SA, *op cit*, p.111.
777 Particularly to neighbouring Southern African nations.
778 OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.462; van Buren 'South Africa: Economy', *op cit*, p.1057.
779 Pocket Guide to SA, *op cit*, pp.115-116.
780 See *Silke on South African Income Tax*, *op cit*, chapter 15; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.4.
781 §26(1) and First Schedule, ITA 1962.

and may result in a lower tax liability for individual farmers where tax liability based on average tax rates of the current and 4 preceding years of assessment is lower than the rate applicable to farming income from the current year.[782] These provisions protect agricultural taxpayers from distorted tax liability based on widely fluctuating revenues typical to the agricultural sector.[783]

Some incentives relate to the **valuation of items** used in the computation of taxable income. For instance, livestock and produce are generally included in computing taxable income liable to normal tax. However, the valuation of these items favours farmers. Livestock are brought to account at low predetermined standard values and not at higher market value thus reducing the ultimate tax liability. Similarly, produce-at-hand is valued at the lower of cost and market value.[784] Acquisition costs of procuring livestock are fully deductible regardless of whether acquired on capital and revenue account.[785] Outlays expended on the establishment and maintenance of plantations are fully deductible subject to certain restrictions in respect of acquisition costs.[786]

Other incentives affect capex outlays. Generous **capital allowances** permit the full deduction of farming development expenditure in the year incurred. Deductible expenses include outlays to control weeds and soil erosion; expenses for the construction of dipping tanks, roads, bridges, dams, irrigation and electrification facilities; and the cost of the erection of fences.[787] Other incentives provide for the tax deductibility of losses arising from drought, fire, plague and government-organised livestock reduction schemes.[788] However, these deductions are only permissible subject to ring-fencing restrictions limiting possible deductions to income derived from farming activities. Indefinite **carry forward provisions** permit unredeemed capital allowances for

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782 ¶19(2) First Schedule, ITA 1962.
783 Similar provisions apply to sugar cane and other plantation businesses.
784 *Silke on South African Income Tax, op cit*, §§15.11-15.14.
785 ¶8, First Schedule, ITA 1962.
786 Unrelieved deductible acquisition costs may be carried forward but all such deductions are restricted by ring-fencing provisions to gross income attributable to the particular plantation: ¶15, First Schedule, ITA 1962.
787 ¶12(1), First Schedule, ITA 1962.

farming capital development expenditure to be set off against future farming income.[789] **Special capital allowances** applied at rates of 50:30:20 percent permit the expensing of capex on machinery, implements, utensils and other items acquired for farming use over 3 years.[790] These general and special capital allowances operate irrespective of any resultant assessed loss.[791]

Agricultural (and other) cooperatives benefit from a range of tax incentives providing special deductions by way of depreciation capital allowances for certain items of machinery and plant;[792] storage or packing machinery and plant;[793] other processing facilities;[794] and certain bonuses, transfers to price stabilisation funds and provisions for losses.[795] **Donations tax exemptions** are also applicable to the transfer of certain farming rights.[796]

The numerous tax incentives available for farming and plantation activities could be either explained by past historical reasons or current economic rationales given the relatively low level of rainfall and irrigation systems and the sensitivity of agriculture to recurrent drought conditions. Power-generation, like agriculture, is highly dependant on the level of annual precipitation. The next section considers incentives for the energy, power-generation and mining sectors.

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788 ¶¶13 and 17, First Schedule, ITA 1962.
789 ¶12(3), First Schedule, ITA 1962.
790 §12B ITA 1962.
791 Badenhorst, *Taxation & Investment in South Africa, op cit*, ¶15.4.5.
792 *Viz.*, 5% straight-line depreciation allowances.
793 At 50:30:20 rates: §12B ITA 1962. Less generous allowances may be available under §12C ITA 1962.
794 *Viz.*, 20% straight-line depreciation allowances.
795 §27(2)(a), (g) and (h), ITA 1962.
796 As between donor and child: §56(1)(m), ITA 1962.

4.2.2. ENERGY & MINING

4.2.2.1. Energy & Power

South Africa has modest oil and gas reserves[797] relying on abundant coal reserves[798] to meet much of the domestic energy demand.[799] Local coal is relatively cheap and serves as feedstock for three oil-from-coal plants operated by South African Coal, Oil and Gas Corporation (hereafter: SASOL). These plants have the combined capacity to produce enough synthetic liquid-fuels to meet 41% of the local fuel demand[800] and also provide hydrocarbon inputs for the petrochemicals industry.[801] Similarly, PetroSA operates gas-to-liquid facilities using natural gas feedstock from offshore gas fields to meet 7% of the local liquid-fuel demand.[802] Despite the contribution of coal and natural gas, South Africa remains dependent on imported petroleum and refines crude oil imports to meet 64% of domestic demand.[803] However, the recent strength of the rand[804] has helped to reduce the effects of rising global oil prices on the balance of trade position.

South Africa's Electricity Supply Commission (Eskom) is a world-class utility and operates an effective monopoly supplying 95% of the nation's electric power.[805] Eskom ranks among the top ten globally in respect of sales and

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797 Proven oil reserves currently stand to 29.4m barrels. Recent discoveries of gas deposits at Mossel Bay (Cape Province) have yielded significant natural gas deposits of 30,000m cubic meters: van Buren 'South Africa: Economy', *op cit,* p.1058.

798 In 2001 South African coal reserves ranked globally at 5th as regards size, 4th as regards exports and 6th as regards production capacity: *ibid,* p.1058.

799 Local coal provided 73% of domestic energy demand in 2001: OECD/AfDB *African Economic Outlook 2003/04 – Country Studies: South Africa, op cit,* p.288.

800 SASOL 1 was commissioned in 1955; SASOL 2 and 3 were commissioned in the 1970s in response to the threats of international sanctions, petroleum embargos and high petroleum prices. The plants are the largest of such installations in the world.

801 SASOL's interests in the petrochemical industry include its acetic plant, chemical plants and a new Sasol Petroleum Temane (SPT) gas-processing plant: van Buren 'South Africa: Economy', *op cit,* p.1058.

802 Pocket Guide to SA, *op cit,* p.132.

803 *Ibid,* p.131.

804 The strong rand has been fuelled by high global prices for exported commodities (diamond and platinum), improved international credit ratings and net capital inflows: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa, op cit,* p.467.

805 Eskom produces two-thirds of Africa's electricity and supplies power to several Southern African countries: van Buren 'South Africa: Economy', *op cit,* p. 1058. However, recent reforms will see new independent power producers being

generation capacity[806] although increasing demand and lagging investment in capacity has recently affected the normally uninterrupted power supply.[807] Eskom relies mainly on coal-fired generators to generate its 39,154MW capacity, though nuclear,[808] petroleum-fired and hydro-electric plants complement the coal-fired generators. Although South Africa lacks sufficient energy-fuel resources to guarantee self-sufficiency, its substantial solid mineral endowments more than compensate for this shortcoming.

4.2.2.2. **Mining**

South Africa possesses immense mineral wealth ranking first in global gold, platinum-group metals, chrome, ferro-chromium, alumino-silicates, manganese and vanadium reserves. Its diamond,[809] ferro-manganese, iron ore and coal reserves are also significant. Historically, mining has been the most dominant sector, contributing 20% of aggregate GDP in 1980. Post-World War II gold discoveries in the Free State, Far West Rand, Klerksdorp and Evander regions have exceeded aggregate output from the original Witwatersrand mines. Gold output has gradually declined after a record 1,000 metric tonnes were mined in 1970. In 2006, gold production contracted 13% to 297.3tonnes (the lowest level since 1923)[810] and in 2008, China replaced South Africa as the world's largest producer of gold.[811] Factors contributing to the reduced gold mining earnings include rising productions costs, depressed prices due to large sales

introduced to compete with Eskom: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.469.

806 OECD/AfDB *African Economic Outlook 2003/04 – Country Studies: South Africa*, *op cit*, p.288.

807 OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.499.

808 Eskom's 1,800 MW Koeberg Nuclear Power station was commissioned in 1976 and its twin reactors have the capacity to meet 6% of local electricity demand.

809 Diamond production has declined reducing South Africa's ranking to 5th *vis-à-vis* global production behind Australia, Botswana, the Democratic Republic of Congo and Russia. However, De Beers (a South African company) leads in global diamond markets accounting for 60% of worldwide trade. *SA 2005-2006 South Africa at a Glance* (Editors Inc., Greenside, South Africa: 2005) p.154.

810 OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.488.

811 Charlotte Mathews, 'Booming China is the world's new Egoli', Business Day (Johannesburg, South Africa 18.01.08) <http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=3123814> accessed on 05.02.08.

of gold reserves,[812] the exhaustion of easily accessible ore and the recent strength of the rand.[813] The industry has reacted by consolidating interests with the reduction of 48 gold-mining companies into just 11 firms over the decade to 2004.

Policy on energy and mining activities are implemented by the Department of Minerals and Energy under the direction of the relevant Minister. As the tax treatment for mining for natural fuels and solid minerals is broadly similar under South African law, tax incentives for both these sectors are considered together in the next section to avoid undue repetition.

4.2.2.3. Tax Incentives for Energy & Mining[814]

Mining and mining operations generally connote any method or process by which any mineral (inclusive of natural oil[815]) is won from the soil or any substance or constituent thereof.[816] Mining operations may be divided into mining for gold,[817] mining for natural oil and mining for other minerals.[818] Tax rates vary depending on the nature of the taxpayer and the mining activity. Mining income accruing to non-corporate taxpayers is taxed based on ordinary, progressive graduated tax rates. For companies, the type of mining activity is crucial. Natural oil and gas mining companies suffer tax at an effective rate of 58%[819] subject to ministerial approval of applications for rate deductions. Gold

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812 Sales of gold reserves by IMF and the British Bank of England in 1999 depressed global gold prices to US$252.90/troy ounce, well below the production costs of many gold producers. However, global gold prices have recovered since 2004: van Buren 'South Africa: Economy', *op cit*, p.1057.

813 Pocket Guide to SA, *op cit*, p.127.

814 See *Silke on South African Income Tax*, *op cit*, chapter 16; see also Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.1.

815 Natural oil is defined as any liquid or solid hydrocarbon or combustible gas but excludes coal, bituminous shales, certain stratified deposits and marsh or other surface gases.

816 §1 ITA 1962.

817 For tax purposes, this includes mining for uranium, silver, osmiridium and pyrites: *Silke on South African Income Tax*, *op cit*, §16.11.

818 Other minerals include silver, coal, copper, tin, manganese, tungsten, marble, limestone, salt and certain types of fireclay: *ibid*, §16.2.

819 As a result of the 30% normal tax and an additional 40% on the residual post-normal tax income: §5(2A)(a), ITA 1962.

mining companies are exempt from donations tax[820] but are liable to normal tax according to various formulae[821] which are applied to each individual mine and ensure that the more profitable mines suffer tax at a higher rate.[822] The normal tax rate of 30% applies for all other mining companies including diamond mining companies.[823]

Normal depreciation tax allowances[824] are replaced by special deductibility rules for capex incurred in mining operations. As with capex on farming development, **capital outlays** for mining operations[825] are usually **deductible in full** in the year incurred[826] subject to ring-fencing restrictions limiting possible deductions to taxable mining income derived (usually from the particular mine)[827] as reduced by cumulative mining assessed losses brought forward.[828] These cumulative assessed losses are reduced by any returns or rebates which remain after being setoff first against current capex and then unredeemed capex.[829] Any excess of such returns and rebates over redeemable capex is taxed at the higher of 30% or a determined average rate of tax.[830] **Prospecting expenses** (including outlays on boreholes, survey work, trenches and pits) incurred on revenue account are eligible for special allowances only

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820 Gold and diamond mining companies are treated as public companies: §38(2)(g) and §56(1)(n) ITA 1962.

821 The formula applicable depends on whether the company concerned elects to pay STC (here the rate is [$\boldsymbol{y=35-(175\div x)\%}$]) or opts out (and pays tax at a higher rate based on another formula:[$\boldsymbol{y=45-(225\div x)\%}$]): SARS Tax Rates for 2005/2006.

822 See 'Explanatory Memorandum on the Income Tax Bill, 1990' WP 2-'90 at 4, cited in *Silke on South African Income Tax*, *op cit*, §16.11.

823 ¶2(a) of Schedule 1 to *Taxation Laws Amendment Act 16 of 2004*. Diamond mining companies are treated as public companies and exempt from donations tax: §38(2)(g) and §56(1)(n) ITA 1962. However, mining taxpayers may also be liable to other taxes including transfer duty, VAT, establishment and services levies.

824 Including the §11(e) wear-and-tear allowance; §11(f) lease-premium allowance; §11(gA) intellectual property allowance; and §11(o) asset alienation allowance.

825 Including capex (on shaft sinking, mining equipment, plant, facilities and buildings), certain items of pre-production opex, private motor vehicles (amortised over 5 years) and amenities (including housing, schools, health and other facilities for employers and their families – amortised over 10 years): §36(11) ITA 1962.

826 An exception is made for new mines, in that capex is accumulated and deducted, with current year expenditure, in the year the production commences and income liable to tax is generated (subject to a further 25% cap): §36(7G) ITA 1962.

827 Unless ministerial waiver of this restriction is obtained: §36(7F) ITA 1962.

828 §36(7E) ITA 1962.

829 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.1.3.

830 ¶2(a) of Schedule 1 to *Taxation Laws Amendment Act 16 of 2004*.

where mining income is generated.[831] Gold and natural oil mines are eligible for 10%[832] or 12%[833] capital allowances on the aggregate amount of certain capex associated with their acquisition and development.[834] A special allowance is applied at 10% or 5% on the cost, respectively, of **pipelines or electrical lines and cables utilised** in the transportation of natural oil or the transmission of electricity.[835] **Rehabilitation costs** also attract special tax treatment and promote environmentally-friendly mining operations.[836] Recent fiscal proposals indicate the possibility for special measures targeted at taxing (and relieving) windfall gains (and losses) from synthetic fuels and bio-fuel products.[837]

The tax regime for oil and gas exploration is established in terms of the *1965 Prospecting Lease OP26* which provides incentives by way of a stabilisation regime. Essentially, oil and gas operators may elect to be taxed under the 1977 regime or the current fiscal regime. The OP26 regime was slated to expire in June 2007 and its provisions were incorporated into the Tenth Schedule to ITA 1962 effective from 2 November 2006.[838] The Tenth Schedule provides numerous incentives for oil and gas operators. Maximum tax rates of 29% and 32% are set for domestic and foreign oil companies. A maximum STC rate of 5% applies although pre-existing holders of OP26 leases enjoy exemption from STC. There are generous immediate capital allowances providing **multiple deductions of 200% and 150%** respectively for **exploration and production capex**. These allowances are complemented by provisions for **loss relief**. Assessed losses from exploration and production activities may be set-off against related income without restriction and 10% of these losses may be

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831 §15(b) ITA 1962. Where no income is produced, deductions may be made under a general deductions formula. Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.1.4.
832 For post-1973 gold mines and other deep level gold mines.
833 For post-1990 gold mines and natural oil mines.
834 §36(11)(c) ITA 1962; *Silke on South African Income Tax*, *op cit*, §§16.14 and 16.15.
835 Applied at 10% (pipelines) and 5% (lines and cables): §12D ITA 1962.
836 Essentially, provisions allow bespoke tax-exempt companies financed by tax-deductible contributions to execute such rehabilitation works: §10(1)(cH) ITA 1962.
837 SARS Budget Tax Proposals 2007/8, p.26.
838 Medium Term Budget Policy Statement 2006 (Pretoria: 25 October 2006), p.49.

setoff against unrelated investment income. Finally, any unrelieved losses may be carried forward indefinitely.[839]

While these tax incentives appear to be quite generous, they are generally constrained by the ring-fencing provisions which limit their scope by closely linking the income earning process with tax deductibility. Similarly, the important capital-revenue distinction disallows outlays for the acquisition of land and mining prospecting rights from being deductible except in special circumstances where these outlays are directly linked to the production of income.[840] The use of ring-fencing restrictions to control the scope of tax incentives is not unique to the energy, power-generation and mining sectors. It also features prominently in tax incentives for financial leases.

The next section outlines taxation imposed on financial services activities and highlights available tax incentives.

4.2.3. FINANCIAL SERVICES

4.2.3.1. **Overview**[841]

The South African financial services sector is the most advanced in Sub-Saharan African and is relatively well-developed compared to middle income emerging economies elsewhere. International confidence in the government's prudent and disciplined macroeconomic policies has been reflected in the enhanced country ratings given by Moody's[842] and Fitch[843] in August 2005[844] aligning South Africa with similarly-ranked Chile, Mexico, Poland and Thailand. Prior to 1995, South Africa operated a dual exchange system whereby non-residents could acquire 'financial' rands at a discount to fund inward

839 Tenth Schedule to ITA 1962.
840 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.1.2; *Silke on South African Income Tax*, *op cit*, §3.36.
841 *SA 2005-2006 South Africa at a Glance*, *op cit*, p.154.
842 Moody's South African country debt ratings were upgraded from Baa2 to Baa1.
843 Fitch: From BBB to BBB+.
844 Standard & Poor's: BBB+: OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.490.

FDI.[845] The dual exchange rate system and financial rand were abolished on 13 March 1995 in favour of a single floating exchange rate with the South African Reserve Bank (hereafter: SARB) intervening indirectly[846] to manage the rand's volatility. However, despite these exchange control reforms, **Rendani Neluvhalani** (Director, International Tax: Ernst & Young South Africa) observed that restrictive procedures remained requiring pre-approvals with the Reserve Bank before investment transactions could be consummated.[847]

The banking sector is regulated by the SARB[848] while non-bank financial institutions are regulated by the Financial Services Board. Banks are regulated under the *Banks Act 94 of 1990.* The banking sector is dominated by four[849] South African banks – Absa, First Rand, Nedbank and Standard – following banking consolidation between 2002 and 2003. However, many foreign banks have investment banking operations, branches and authorised representative offices.[850] Other institutions are active in the insurance, pensions, asset management and collective savings (stokvels) sub-sectors. Insurance companies are regulated by a Registrar of Insurance under the *Long-Term Insurance Act 52 of 1998* and the *Short-Term Insurance Act 53 of 1998* depending on the type of business transacted. The Registrar exercises powers of over the registration, returns, financial resources and organisation of insurance companies in the interests of policy holders.[851]

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845 Residents however, could only trade in the 'commercial rand' – which varied widely due to the large capital outflows precipitated by the political crises of the 1980s and early 1990s.

846 The SARB influences exchange rates by acquiring rand and foreign exchange on spot and forward markets. The SARB's Exchange Control Department is responsible for regulation in terms of the *Currency and Exchanges Act 1961*.

847 Interview with Rendani Neluvhalani: Director, International Tax; Ernst & Young Advisory Services Ltd, Ernst & Young RSA National Office (Johannesburg, Thurs 24 May 2007).

848 The SARB acts in conjunction with the Ministry of Finance but enjoys significant autonomy from the latter in matters of banking regulation and monetary policy. Interest rates are influenced by setting the 'repo' rate at which commercial banks borrow from the SARB.

849 A fifth group (Investec) also has significant presence in banking services.

850 Stuart Theobald 'Banking's immigrants settle in', *Phambili SA* Edition 2, June/July 2004, WriteStuff Publishing cc (Sandton, South Africa, February 2004) pp.5-7.

851 Charl Hugo and Richard Stevens, Chapter 9: 'Commercial Law,' in *Introduction to the Law of South Africa*, *op cit*, p.342.

The Johannesburg Stock Exchange (hereafter: JSE) was established in 1887 and is the largest stock exchange in Africa with a domestic market capitalisation of over US$711billion (2006).[852] JSE operates trading in equities, financial instruments and agricultural derivatives through its Main Board, Development Capital Market, Venture Capital Market, AltX (for SMEs) and YieldX (for interest rate spreads) exchanges. The well-developed bond market provides debt financing for companies, governments and other institutions. The Bond Exchange of South Africa (BESA) regulates bond issues. A variety of money market instruments are utilised ranging from traditional securities[853] to innovative financial derivatives.[854] Securities law and regulation is provided for mainly by the *Stock Exchange Control Act 1 of 1985*, the *Financial Markets Control Act 55 of 1985* and the *Insider Trading Act 135 of 1998.*

Recent fiscal policy has sought to reverse the negative capital flows prevalent towards the end of the *apartheid* era. Foreign exchange tax amnesties were granted to residents who repatriated funds illegally routed out of jurisdiction by circumventing the strict foreign exchange controls of that time.[855] By February 2006, 42,672 tax amnesty applications had been processed yielding R68.6billion in disclosed foreign funds and R2.9billion in tax revenues from tax amnesty levies.[856] Other tax incentives to promote activities of local and international investors, financial intermediaries and other market participants are considered in the succeeding section.

4.2.3.2. Tax Incentives for Finance

Providers of financial services are subject to several taxes in addition to **normal tax** which is charged at 30% on taxable income. Investment income

[852] Up by 29.5% from 2005: World Federation of Exchanges Annual Report and Statistics 2006, *Equity 1.1 'Domestic Market Capitalization'* <http://www.world-exchanges.org/WFE/home.asp?menu=11&document=4233>, p.66.
[853] *Viz.*, treasury bills, certificates of deposits and other negotiable instruments.
[854] Including options, swaps, futures, forwards, and deeply discounted instruments.
[855] Peter Surtees 'South African Budget Offers Broad Range of Tax Breaks, Incentives' March 10, TNI 2003 at p.931.
[856] SA Budget Speech 2006, *op cit*, p.10.

from interest and option premiums are accrued evenly over the life of the relevant instrument and included in taxable income.[857] Issuers of debentures, discounted and other financial instruments are allowed to deduct the associated interest, discount or premium on an accrual basis provided incurred in the production of taxable income.[858] Foreign exchange gains and losses[859] are treated symmetrically with gains being included in arriving at taxable income and losses being tax deductible.[860]

Taxpayers operating in the financial sector may be liable to **other taxes** including transfer duty, VAT,[861] establishment and services levies. Liability for **regional establishment levies** is contingent on the concerned financial institution being classified as a financial enterprise, carrying on business as an investor of money. While more active investment activities (e.g. management of shares in subsidiaries by an investment holding company) result in classification as a financial enterprise,[862] more passive investment activity[863] would not attract such tax classification or liability.[864]

Special provisions apply to **insurance business** where short-term and long-term insurers receive different tax treatments.[865] Short-term insurers[866] are taxed at the 30% normal tax rate.[867] Long-term insurers[868] must comply with certain regulations and segregate their funds under a four-fund approach into:

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857 §24J ITA 1962.
858 §§24J, 24K and 24L, ITA 1962.
859 These exchange differences may result from transaction, realisation or translation events and their quantum is determined by prescribed prevailing exchange rates.
860 §24I ITA 1962.
861 VAT has essentially replaced the former levy on financial services given its widespread application to supplies of financial services: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶¶21&22.
862 Classification as a financial enterprise attracts liability for regional establishment levies.
863 Such as the receipt of investment income from the occasional investment of cash surpluses by a conduit company or a non-financial trading/operating company.
864 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, chapter 20.
865 *Silke on South African Income Tax*, *op cit*, §17.13.
866 Short term insurance covers indemnity insurance business (the insurance of fire, marine and motor vehicle risks).
867 §28(2) ITA 1962.

an untaxed policyholder fund,[869] an individual policyholder fund, a corporate policyholder fund[870] and a corporate fund[871].[872] Taxable income accruing to the last three funds is taxed at the 30% normal rate while that accruing to the first fund (untaxed policyholder fund) is taxed at 25%.[873] Other legislation[874] provides for the taxation of gross income and net rental of on otherwise exempt pension, provident and retirement annuity **(retirement) funds**.[875]

The South African tax treatment for **leases** is quite sophisticated compared to that of the other study countries. Generally, a symmetrical treatment is applied to lease payments. Lessors are liable to tax on lease premiums and the value of certain improvements to leased property by the lessee (all included in the computation of gross income). Conversely, lessees may deduct the cost of these premiums and improvements (if taxable in the hands of the lessor).

Numerous **tax incentives** apply for various types of financial sector activity.[876] For instance, special tax incentives apply to **leases**.[877] The leasehold improvement allowance permits lessees to write off certain costs over the shorter of the unexpired term of the lease or 25 years.[878] As noted above, lessors are liable to tax on the value of leasehold improvements. In recognition of the fact that the benefits inherent in such enhancement to the lease property will only be enjoyed by the lessor at the end of the lease, special and **innovative allowances** permit the lessor to reduce the taxable amounts to the

868 Long term insurance includes life, assurance, industrial property and non-cancellable medical/disability insurance.
869 To hold funds relating the accounts of certain policyholders who are either tax-exempt or liable to tax at lower rates.
870 For individual and corporate policyholders respectively.
871 The residual funds not attributable to policyholders are allocated to the corporate fund on the insurer's account.
872 §29 and §29A, ITA 1962.
873 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.2.
874 *Tax on Retirement Funds Act 38 of 1996*.
875 *Silke on South African Income Tax*, *op cit*, §§17.14B-17.14W; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, chapter 26.
876 However, some generally applicable incentives (notably machinery and plant capital allowances) are specifically excluded for banks, insurers and other providers of financial services: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, p.126.
877 §23A and §11(g),(h), ITA 1962.
878 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶¶10.5.6 & 15.8.

net present value of the improvements. This is particularly valuable for lessors with long term and **finance leases**.[879] However, **ring-fencing provisions** restrict the benefit of capital allowances enjoyed by finance leases of plant and machinery in the manufacturing, hotel, farming and aircraft sectors. These provisions limit these capital allowances to the amount of taxable income derivable from the leasing business.[880]

Operating leases[881] are exempt from ring-fencing restrictions permitting tax allowances to be utilised against leasing as well as non-leasing income. Special provisions apply to **sale and lease-back transactions** for a variety of assets and industries. These limit capital allowances to the lower of cost to the lessee or market value at the time acquired.[882] **Short-term insurers** may benefit from deferral allowances for unexpired risks, notified but unpaid claims and un-notified and unpaid claims. These deferral allowances are re-calculated and added back in each year of assessment. Tax deductions for transfers to contingency or catastrophe funds are also permitted [883]

Some incentives apply to financial transactions involving shares and other securities. Various provisions[884] grant **corporate rollover relief** to reduce capital gains tax, income tax, donations tax, STC and other transaction taxes[885] otherwise payable as a result business reorganisations and other corporate

879 *Silke on South African Income Tax*, *op cit*, §8.75; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.8.

880 However, un-utilised capital allowances may be carried forward indefinitely and set-off against future leasing income.

881 An operating lease is one concluded by the lessor in the ordinary course of business of letting property (other than of banking or financing) if the property can be hired by members of the general public for periods less than 1 month, and maintenance/repair costs and the risk of loss/destruction remain with the lessor: §23(1), ITA 1962.

882 Where the lessee is a tax-exempt body, the transaction is treated as a loan: the lessor is not taxed on the gross rentals or allowed to enjoy capital allowances: §23G, ITA 1962.

883 Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.2.3.

884 §§41-47, ITA 1962.

885 *Viz.*, stamp duties, marketable securities tax, uncertified securities tax and transfer duty.

group transactions.[886] These provisions apply to relieve taxation on company formations,[887] certain share-for-share transactions,[888] business combinations (including mergers, conversions and amalgamations),[889] intra-group[890] and un-bundling activities,[891] liquidation, winding up and deregistration transactions.[892] These incentives prevent tax and duty considerations from discouraging or impeding legitimate corporate actions involving incorporation, share swaps and exchanges, mergers, acquisitions and amalgamations, unbundling and divestitures of shares to shareholders, and corporate dissolutions. However, there are limitations on the availability of corporate rollover/group relief to financial institutions and non-resident entities.[893] Also, special anti-avoidance rules ring-fence capital gains and taxable income[894] for 18 months and preclude the disposal of built-in gain assets through transfers to loss-endowed companies.[895]

Recent fiscal policies propose various changes providing moderate tax relief to combat wage inflation and fiscal drag.[896] The sale of shares held for more than 3 years is to attract capital gains tax.[897] However, various tax thresholds are to be increased for estates duty, donations to public benefit organisations, exemption from capital gains tax payable at death and tax-free savings.[898]

New, innovative **venture capital tax incentives** are proposed under the 2008 Budget to improve the access of high-growth, high-technology firms to critical

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886 This relief applies to the disposals of capital and depreciable assets, inventory, trading stock, and donations of chargeable assets as a result of the asset transfers inherent in business reorganisations.
887 §42 ITA 1962.
888 §43 *ibid.*
889 §44 *ibid.*
890 §45 *ibid.*
891 §46 *ibid.*
892 §47 *ibid.*
893 §42 *ibid.*
894 Derivable from disposals of trading stock, capital and allowance assets.
895 See §§42(6), 43(6), 44(5), ITA 1962. See also the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002 [WP2-'02] at 17, cited in *Silke on South African Income Tax*, *op cit*, chapter 24.
896 Budget Review 2008, pp.64,66.
897 SARS Budget Tax Proposals 2007/8, pp.2,3.
898 From R2.5million (2006) and R3.5million (2007): *ibid*, p.10.

finance. Non-mining companies with annual turnovers (or gross assets) of up to R14million (R7million) will be entitled to a general, up-front deduction of 30% (subject to certain annual caps). For junior mining exploration companies a 50% deduction applies.[899] Finally, as **Robyn Nathan** (Partner, International Tax: KPMG South Africa) observed South African tax law provides a full exemption for interest accruing to foreign-sourced debt finance as there is no withholding tax levied on interest paid to non-residents in terms of §10(1)(H) ITA 1962.[900]

This section has outlined certain aspects of the tax system and associated fiscal incentives for the financial sector. The next section focuses on physical infrastructure and social services and highlights the role of tax incentives in facilitating the provision of these services.

4.2.4. INFRASTRUCTURE & SERVICES

4.2.4.0. Introduction

South Africa has some of the best developed infrastructural facilities in Africa in terms of telecommunications, transportation and basic social services. However, it faces significant challenges in ensuring that a wider section of the population benefits from these facilities. This section provides an overview of the challenges facing the provision of adequate infrastructure and social services to citizens and the role of tax incentives within the context of the related tax system.

4.2.4.1. Information & Communications Technology/Electronics

South Africa has extensive and well-developed **telecommunications** infrastructure. Telkom[901] was privatised in 1997[902] and listed on the JSE and

[899] Budget Review 2008, p.64; SA 2008 Budget, p.21.
[900] Interview with Ferdi Vorster: Director, Corporate Tax and Robyn Nathan: Partner, International Tax; KPMG Services (Proprietary) Ltd, KPMG RSA National Office (Johannesburg, Thurs 17 May 2007). See also §10(1)(H) ITA 1962.
[901] The state telecommunications company.

New York Stock Exchange.[903] Vodacom (Telkom's subsidiary) dominates the mobile telephony market with a 61% market share (2004).[904] The sector has grown since the late 1990s to become the world's 4th fastest growing cellular market.[905] Private operators include the MTN group[906] and Cell C.[907] Current reforms include the licensing of a Second National Carrier to compete with Telkom.[908]

Information and communications technology/electronics (hereafter: ICT-E) is a significant sector controlled mainly by listed companies, the local operations of IT multinationals and a small number of local unlisted companies. Key sub-sectors include the provision of integrated systems, storage systems, software solutions, computer hardware, semiconductors, telecommunications equipment and security systems. Other potential growth areas are the supply of electro-technical systems[909] and offshore or captive call centres.[910] Black Economic Empowerment initiatives have been implemented

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[902] With Malaysian interests (Thintana Communications LLC) investing R5,600million to acquire a 30% stake, reducing the government's stake to less than 39.3% (2004): van Buren 'South Africa: Economy', p.1059.

[903] Raising a record R3.9billion on the first day of listing alone: Pocket Guide to SA, *op cit*, p.133.

[904] Pocket Guide to SA, *op cit*, p.96.

[905] The cellular phone market dwarfs the fixed-line market (18million cell phone users as against 4.8million land-lines): OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.469.

[906] As observed in Chapter 3, MTN is a leading telecommunications operator in Africa. MTN's South African operations secured a 38% market share in 2005 growing 28% from 6.270million to 8.001million subscribers in that financial year. In the same period, revenues and profits after tax increased 21% and 47% to R29billion and R7.3billion respectively: see MTN Group Ltd Annual Presentation for year ended 31 March 2005 (presented to analysts on 20 June 2005).

[907] C Cell commenced operations in 2001 and has grown its subscriber base to 1.5million by year end 2002: Pocket Guide to SA, *op cit*, p.96.

[908] In December 2005, the Independent Communications Authority licensed a coalition of business interests to provide fixed-line telephony services as a Second National Carrier: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.469.

[909] For integrated defence systems, fire and security detection systems, electricity infrastructure, fine calibration and other instrumentation systems.

[910] The majority of call centres are clustered in the Greater Johannesburg locality with a strong leaning towards the financial services sector. However, the growth of call centres may be constrained by skills shortages and the relatively high costs of calls and voice-over-internet services (due to the legacy of Telkom's monopoly and the strong rand): Annie Gaithwaite, 'The Destination: South Africa Call centres in South

under an empowerment charter and by cooperation between industry and the Departments of Trade & Industry and Communications. Much of the sub-sector is concentrated in the Gauteng Province's high-tech information technology corridor in Midrand.

Physical connectivity through transportation systems, hubs and services is considered in the next section.

4.2.4.2. **Transportation**

Despite lacking navigable inland waters, South Africa has one of Africa's most developed transportation infrastructure with extensive **rail**[911] and **road**[912] networks. There are 9 international **airports** (including Cape Town, Durban and Johannesburg) owned and managed by the Airports Company of South Africa (ACSA). The **ports**[913] are operated by the National Ports Authority (hereafter: NPA). The shipping sector is dominated by the private sector[914] and recent economic policy has favoured privatisation and commercialisation supervised by certain public bodies.[915] Nevertheless, the transportation sector remains dominated by the state parastatal Transnet Ltd and its subsidiaries. These subsidiaries include Spoornet and Metrorail (railways, passenger coaches), National Ports Authority (sea ports), South African Airways (or SAA: airlines), Freight Dynamics (roads) and Petronet (petroleum pipelines). Transportation is a significant employer though the restructuring of Transnet since 1990 has reduced its workforce significantly. However, Transnet intends

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Africa' *South Africa* Vol. 3 Issue 1 2005 International Marketing Council of South Africa (Johannesburg, 2005) pp. 46-47.

911 The 31,400km rail network comprises a third of all railway tracks in Africa.

912 Similarly, the road network is the longest of any African nation and features 500,000km of classified roads although only 20% of this was paved in 2001: van Buren 'South Africa: Economy', *op cit*, p.1058.

913 Durban is the largest port handling over 55million metric tonnes of cargo annually. Other key ports include Richards Bay, East London, Port Elizabeth, Mossel Bay, Cape Town and Saldanha.

914 Indeed, recent proposals should see an increase in private sector participation in the management of ports: van Buren 'South Africa: Economy', *op cit*, p.1058.

915 Including the South African National Roads Agency Ltd, the South African Maritime Safety Authority, the Cross-Border Road Transport Agency and the Civil Aviation Authority: Pocket Guide to SA, *op cit*, pp.105-110.

to invest R78billion in upgrading rail infrastructure and rolling stock ahead of the FIFA 2010 World Cup under recent budgetary proposals.[916]

The next sections highlight current realities in the provision of water, housing and basic services.

4.2.4.3. **Water & Housing**

Securing adequate **water supplies** for industrial and domestic use has become increasingly challenging despite planned enhancements to the capacity of the Vaal River from drainage systems passing through the Tugela Basin. A US$3.770billion Highlands Water Project has been proposed by the South African and Lesotho governments to meet projected requirements. Other initiatives include the construction of a second dam at Klipriviersberg (to serve Johannesburg and the Gauteng Province) and water supply projects for the provision of drinking water in poorer communities.[917]

Providing adequate **housing facilities** has been a significant challenge.[918] The post-*apartheid* ANC-led government has expended huge sums on housing initiatives to provide decent and secure homes for the large, economically-deprived section of the population. Housing assets worth R48billion were transferred by the state between 1994 and 2003 benefiting 6million citizens.[919] Numerous public and public-private partnerships are being implemented to ensure urban renewal of inner city and other slums, improve service delivery by combating housing fraud and balance rural/urban development.[920] Other initiatives aim to deliver more affordable housing; improve access and terms of

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[916] SA 2008 Budget, pp.13-14.

[917] Reaching 85% of all households in 2001: van Buren 'South Africa: Economy', *op cit*, p.1059.

[918] Given the demographical distribution of land between the segments of the population as a legacy of *apartheid* laws under which most non-Whites were denied ownership of and access to real property under influx control and pass laws (such as the *Group Areas Act 41 of 1950*, *Black (Urban Areas) Consolidation Act 25 of 1945*, *Blacks (Abolition of Passes and Co-ordination of Documents) Act 67 of 1952* and *Possession of Illegal Squatting Act 52 of 1951*): Johan de Waal, Chapter 2: 'Constitutional Law,' in *Introduction to the Law of South Africa*, *op cit*, p.57.

[919] Pocket Guide to SA, *op cit*, p.151.

housing; provide mortgages and finance to savers, disabled persons, women, and rural communities;[921] and ensure sustainable rental housing.[922] Initiatives range from the provision of financial facilities,[923] the management of non-performing loans and properties-in-possession[924] to capacity building for housing institutions[925].[926] Despite these efforts and the recent property boom in middle market and upmarket housing, there is still a significant backlog in housing provision particularly for rural communities and the very poor. Similar challenges exist in the provision of education and other socials services.

4.2.4.4. Education & Other Social Services

Education is mainly the responsibility of the central government's Department of Education which acts in conjunction with the nine provincial departments of education. Statistics show progress in the performance of learners at all levels particularly in public schools, universities and technikons. However, there are concerns over quality, particularly in the low number of learners in science/technology, mathematics, business/commerce and engineering.[927] Recent initiatives focus on encouraging education in these sectors as well as providing facilities for flexible/lifelong higher education and training to equip the country with suitably qualified manpower in the academia, professions, technical vocations and industry.[928]

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920 Under the national Housing Programme.
921 Under the Human Settlement Redevelopment Programme.
922 Under the Public Sector Hostel Redevelopment Programme.
923 By institutions such as the National Housing Finance Corporation and the Rural Housing Loan Fund.
924 The Department of Housing operates a joint venture with the Councils of South African Banks and Servcon Housing Solutions to provide debt and property management, recovery and disposal services.
925 Non-for-profit organisations like the Social Housing Foundation provide such capacity development services.
926 Pocket Guide to SA, *op cit*, pp.151-156.
927 The dearth of skilled artisans, technicians and engineers has prompted suggestions for closer links between education and industry through the Joint Initiative for Priority Skills Acquisition (JIFPSA): OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.496.
928 Respectively under Strategic Plan for Higher Education and the Further Education and Training programme: Pocket Guide to SA, *op cit*, pp.137-142.

The agenda for **health and social welfare** services has also been driven by the need to address post-*apartheid* realities. Despite the existence of excellent private medical services and the availability of free primary healthcare services at public clinics, significant segments of the society have inadequate access to healthcare. There are significant shortages of trained physicians and specialists due to the emigration of health professionals to seek better paying jobs abroad. Inadequate initial public policy responses to HIV/AIDS [929] and other communicable diseases have adversely affected the working population and reduce economic productivity.[930] The South African Social Services Agency has increased spending on cash transfers to deal with social welfare needs. The Agency aims at providing income support to the most vulnerable groups, while simultaneously seeking to preserve incentives to work. Recent emphasis has been focused on better social support delivery and reducing benefits fraud.[931] However, expenditure on social services and infrastructure will likely remain within controlled public deficit limits till 2008/09.[932]

Fiscal measures complement these non-fiscal initiatives targeted at providing access to adequate to basic infrastructure and services for all South Africans. Tax incentives to promote these ends are considered in the next section.

4.2.4.5. Tax Incentives for Infrastructure & Services

Most individuals and enterprises engaged in the infrastructure and social services sectors are subject to normal income tax. However, there are certain exceptions. For instance, **telecommunication** enterprises are subject to certain special provisions which provide for a deemed taxable income[933] in the absence of proper accounts which satisfactorily reflect the income generated during the relevant tax year.[934] However, **special allowances** are available at 5% on the

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929 Statistics indicate that South Africa has the largest number of people living with HIV/AIDS in Africa.
930 OECD/AfDB *African Economic Outlook 2003/04 – Country Studies: South Africa, op cit*, p.474.
931 *Ibid*, p.473.
932 *Ibid*, p.466.
933 Equivalent to R10 of taxable income on every R200 of revenue generated.
934 §32 ITA 1962.

cost of capital outlays for **telephone lines or cables** utilised in the transmission of telecommunications.[935] These special allowances also apply to expenditure incurred to erect, construct or install **railways lines** and other affected assets used for the transportation of passengers and goods.[936] Tax incentives for other modes of **transportation** are also available.

Ship and aircraft owners may claim general capital allowances applied on a straight-line basis at 20% per annum over 5 years,[937] or 33.3% par annum over 3 years,[938] or indeed, 40:20:20:20 over 4 years[939] to write off capex.[940] Special provisions allow the treatment of parent and subsidiary shipping companies as a single entity for granting capital allowances and the tax treatment of income and expenses.[941] Other allowances permit ship owners to claim the cost of estimated repairs projected to be incurred up to 5 years in advance.[942] Certain provisions[943] provide tax deductibility for expenditure on the acquisition or construction of aircraft hangars, runways, taxiways at approved airports.[944] Others apply to taxpayers that erect permanent shipbuilding facilities.[945] A special tonnage tax was introduced to stimulate the South African shipping industry. Accordingly, shipping companies would be liable to tax according to the size of their ships and not according to business results, reducing the relevant effective rate of tax.[946] Fiscal policy proposals will permit the tax

[935] §12D *ibid.*
[936] §12D *ibid.*
[937] For new or used qualifying assets acquired on or after 21 June 1993.
[938] For new/unused machinery and plant acquired between 1 July 1996 and 30 September 1999.
[939] For new/unused machinery and plant acquired on or after 1 March 2002.
[940] §12C ITA 1962. These allowances apply with effect from 1 April 1995 and replace a system of capital allowances permitting either (a) a generous 40% first-year initial allowance followed by lower annual allowances or (b) general annual wear-and-tear allowances of 10% per annum for ships and 25% per annum for aircrafts: §14(1) ITA 1962; *Silke on South African Income Tax*, *op cit*, §§8.3-8.8.
[941] §14 ITA 1962; *Silke on South African Income Tax*, *op cit*, §8.11.
[942] §14(1)(c) ITA 1962.
[943] §12F *ibid* (with effect from 1 April 2001).
[944] *Silke on South African Income Tax*, *op cit*, §8.39E; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, pp.183-185.
[945] §13(8) ITA 1962.
[946] Budget Review 2005, *op cit*, p.84.

depreciation of rail locomotives and wagons over 5-years instead of the previous 14-year period.[947]

Scrapping allowances are provided for ships, ship-building facilities, aircraft, aircraft facilities (hangars and taxiways), railway lines and other related facilities that are withdrawn from use for reasons other than cessation of trade (i.e. alienation, loss or destruction of the asset).[948] In addition to these scrapping allowances, **toll road** operators are provided special deductions[949] for certain types of toll road expenditure including expenses on permanent road works and major rehabilitations to road pavements, routine repairs and maintenance of toll roads, associated finance costs and ancillary services.[950] In line with the trend towards non-fiscal incentives, a **taxi recapitalisation project** has been approved under which a cash allowance of R50,000 is paid for each taxi scrapped. The scrapping allowances do not trigger capital gains tax liabilities and, where used for the acquisition of a new taxi vehicle, the owner would be entitled to the full cost for tax purposes.[951]

In the past, income tax exemptions applied to qualifying companies formed to provide **housing utilities** for low-income communities.[952] These have been replaced by income exemptions for similar public benefit companies.[953] The regeneration of decrepit urban and business districts is encouraged by incentives promoting development in certain **urban development zones**.[954] The scheme promotes public-private partnerships between entrepreneurs and local municipalities in 16 designated inner cities.[955] Incentives include initial/first year allowances of 20% followed by either (a) annual 5%

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947 SARS Budget Tax Proposals 2007/8, p.4.
948 §11(o) ITA 1962.
949 Subject to ring-fencing restrictions and limitations on the timing of the deductions: §24G(5) *ibid.*
950 §24G(2) *ibid.*
951 Medium Term Budget Policy Statement 2006, *op cit*, p.45.
952 §10(1)(*c*I) ITA 1962.
953 §30 *ibid*; *Silke on South African Income Tax*, *op cit*, §6.24.
954 §13*quat ibid*; *Silke on South African Income Tax*, *op cit*, §8.115.
955 Local municipalities play a significant role, particularly in designating eligible demarcated areas to benefit from the scheme.

allowances in the 16 succeeding years,[956] or (b) 20% annual allowances in the four succeeding years,[957] depending on the nature of the urban development. These incentives are to be extended for another 5 years till 2014 under Budget 2008 proposals.[958]

Other housing and township development incentives are available for the conversion of undeveloped land into saleable housing units and associated amenities. Certain capital development expenditure[959] is permitted to be apportioned among the number of housing units and deducted as trading stock in the tax year in which these units are disposed. Opex may be deducted in the current tax year. Developers may claim allowances for expenditure they are obliged to incur on future, post-sale development.[960] Developers may also claim suspensive sale[961] debtor allowances which relieve from tax the gross profit element of revenue earned but unpaid or outstanding at the end of the tax year.[962]

Employers providing housing by way of the **erection of dwellings**[963] or **residential units**[964] for their employees are eligible for additional allowances on the cost of the housings facilities[965] or residential units.[966] Employers are

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956 In respect of the erection of new buildings or additions and extensions to these.
957 In respect of improvements to existing buildings which do not alter the exterior framework of such buildings.
958 Budget Review 2008, p.62.
959 Namely expenditure on real property acquisition costs, road construction, water, services and common areas.
960 §24 ITA 1962; *Silke on South African Income Tax*, *op cit*, §17.30 *et seq;* Badenhorst, *Taxation & Investment in South Africa*, *op cit*, ¶15.3.
961 In suspensive sales, the title in the goods or movable property (or to immovable property) only passes upon the receipt of the whole or a certain part of the purchase consideration. The vendor retains title to the property prior to such payment: *Silke on South African Income Tax*, *op cit*, §17.26.
962 §24 ITA 1962.
963 In terms of §11(t) ITA 1962.
964 Self-contained residential accommodation consisting of more than one room (excluding any hotel, hostel or similar accommodation commenced on or after 1 April 1982, and erected under a taxpayer's housing project to provide accommodation for profit or let to a full-time employee): §13*ter*(1) ITA 1962.
965 At 50% of the expenditure donated or advanced: §11(t) ITA 1962.
966 10% initial first year allowances in addition to concurrent 2% annual allowances provided at least 5 units have been let to employees (or in the case of leasehold properties, the lease's term is at least 10 years): §13*ter* ITA 1962.

also eligible for incentives for expenditure on the **education and training** of employees under learnership agreements registered with a Sector Education Training Authority (SETA) or the Department of Trade and Industry. The allowances here are equivalent to the lesser of the annual equivalent of the employee's remuneration (for new employees) or 70% of the annual equivalent of the remuneration (for existing employees) subject, respectively, to a cap of R25,000 and R17,500.[967]

These incentives are some of the numerous incentives provided to employers to increase output, productivity and employment.[968] The next section considers other tax incentives available to employers and other investors in the vital manufacturing sector.

4.2.5. MANUFACTURING & INDUSTRY

4.2.5.1. Overview

The well-developed industrial sector leads other productive sectors in contributing 19% to GDP[969] and providing employment for 14% of the nation's workforce in 2005.[970] Industrial activities tend to be clustered around four key industrial areas[971] particularly in the Gauteng Province.[972] Manufacturing and heavy industry are closely interconnected with other sectors such as the services and ICT-E sectors. The services sector in particular provides essential supplies of professional, managerial, technical and executive skilled labour for manufacturing and industry. As such, any consideration of tax incentives for

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[967] The benefit of these allowances may be clawed-back by the Commissioner where the learnership agreement is prematurely terminated for reason other than for death or dismissal due to physical incapacity: §12H ITA 1962. See *Silke on South African Income Tax*, *op cit*, §8.70A.

[968] South African labour law tends to apply the concept of 'fairness' as a constitutional overlay to basic common law employment contract principles: see *Labour Relations Act 66 of 1995*, *Basic Conditions of Employment Act 75 of 1997* and *Employment Equity Act 55 of 1998;* Christoph Garbers, Chapter 11: 'Labour Law,' in *Introduction to the Law of South Africa*, *op cit*, pp.399-430.

[969] In 2005/06: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.462.

[970] Van Buren, 'South Africa: Economy', *op cit,* p.1055.

[971] Namely Gauteng, Western Cape, Durban-Pinewood and Port Elizabeth-Uitenhage.

manufacturing and industry should be understood with the interplay with these sectors in mind. Metals and engineering lead other manufacturing sub-sectors, with steel and aluminium contributing considerably to output and employment.[973] Vehicle manufacturing contributed 6.4% to GDP and employed 32,000 people in 2004.[974] Textiles however have faced declining fortunes due to a number of factors[975] despite high tariff protections and access to the US markets under the US *African Growth and Opportunity Act.*

Over the years, tax incentive policy has featured prominently in promoting manufacturing and industry. Commentators observe that investments in ferro-chome processing,[976] ceramics,[977] aluminium smelters and fibre-optics occurred as a result of attractive investment incentives.[978] The following sections consider the use of various tax incentive schemes targeted at promoting growth, productivity and employment the manufacturing sector.

4.2.5.2. Tax Holidays for Decentralisation & Industrial Development Zones

Industrial development incentives had an important role in the decentralisation of industry during the *apartheid* years. Black observes that in 1982 the industrial decentralisation policy involved various incentives ranging from **tax holidays to income tax exemptions subject to a 15% withholding tax on certain**

[972] Though the smallest province, Gauteng contributes more than a third of total GDP.

[973] Industrial efficiency is high resulting in relatively low and internationally competitive steel and aluminium prices: van Buren 'South Africa: Economy', *op cit,* p.1055.

[974] OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit,* p.463. However, declines in exports, rising labour costs and poor domestic demand due to income disparities have adversely affected the sector: van Buren 'South Africa: Economy', *op cit,* p.1056.

[975] These include the expiry of the Multi-Fibre Agreement, increasing Asian competition, the strong rand affecting the price competitiveness of exports: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit,* p.462.

[976] Tata Steel of India invested R600million having been lured away from Australia.

[977] Pegasus was investing R208million in a ceramic tile plant in Vereeniging.

[978] Peter Surtees 'South African Tax Update: The Bitter and the Sweet of Incentives' TNI Nov 11, 2002 [2002 WTD 209-5].

remittances.[979] These incentives were provided to encourage local and foreign investors to relocate industrial activity away from the 4 major metropolitan regions of Pretoria-Witwatersrand-Vereeniging, Durban, Cape Town and Port Elizabeth-Uitenhage. Investment was decentralised to the semi-autonomous Bantustans (homelands) and other border areas in line with the *apartheid* policy of separate development.

However, these industrial relocations were almost entirely motivated by political considerations and not sound economics. As such, little new investment was created, existing investment was relocated to inefficient and unviable locations and the costs in revenues forgone escalated from R107million for fiscal year 1982-1983 to R618million for fiscal year 1985-1986.[980] These significant inefficiencies were reflected in the costs-per-job in decentralised areas ranging from R60,000 to R100,000: three or four times the comparative values for metropolitan jobs. Ultimately, the rate of investment declined due to economic recession, political instability and the unsustainable nature of the incentives leading to their gradual withdrawal.[981] The industrial decentralisation policy was succeeded by the industrial development zones tax holiday scheme operative between 1996 and 1999.[982]

Tax holidays were previously available between 1996 and 1999 for eligible new companies and close corporations commencing single-approved manufacturing projects with capital investments in the secondary sector.[983] The scheme was administered by the Board of Manufacturing Development under the oversight of the Department of Trade and Industry. Since its inception on 1 October 1996, the scheme generated R3.7billion in investment in 133 projects

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979 A.H. Black, 'Decentralization incentives and investment in the South African periphery' in Alan W. Whiteside (ed) *Industrialization and Investment Incentives in Southern Africa*, (University of Natal Press, Pietermaritzburg: 1989) pp.121-141.

980 *Ibid*, p.131.

981 *Ibid*, pp.136-140.

982 §37H ITA 1962; Marius van Blerck 'South Africa Introduces Tax Holiday Program' TNI May 12, 1997 [97 TNI 91-17].

983 The tax holiday scheme commenced from 1 October 1996 and was available to projects approved by the Board for Regional Industrial Development by 30 September 1999: Badenhorst, *Taxation & Investment in South Africa*, *op cit*, §10.12.

potentially creating 11,000 jobs.[984] **Cumulative 2-year tax holiday periods** were awarded based on projects meeting 3 separate sets of criteria based on geographical, industry and workforce components. Projects could enjoy a maximum consecutive **tax holiday period of 6 years**. The capital outlays had to be in excess of R3million and expended on land, buildings, plant and machinery to be utilised in manufacturing processes. The scheme emphasised innovative and viable projects which enhanced the local skills-base and utilised competitive technology. However, these tax holidays were phased out from September 1999 and replaced by other more targeted incentive schemes.

4.2.5.3. General Tax Incentives

South African tax law features several fiscal incentives of a general nature, as well as more specifically-targeted incentives. General incentives include the tax deductibility provided by the **general deduction formula's** 'positive' and 'negative' tests[985] which effectively allow the tax deductibility of only such expenditure and losses which are actually incurred, on revenue account, during relevant tax year in the production of income, having been expended for the purposes of the trade.[986]

Another set of broadly targeted incentives are the **wear-and-tear and depreciation allowances** available for items of **industrial plant and machinery**.[987] These allowances are applied on a straight-line basis[988] and granted at the discretion of the Commissioner at rates that fairly reflect the amounts by which relevant assets have been diminished by reason of wear and tear. In determining the applicable deemed or base costs, direct costs of acquisition, installation, erection, shipping, delivery and repairs are relevant. However, finance costs, pre-production interest, and other indirect or artificial

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[984] Business Day article 'Replacing Tax Holidays', 22 September 1999, cited in R Stretch and J Silke, Taxgram Database, accessed at University of Johannesburg's Law Library.

[985] In terms of §§11-19 and §23, respectively, ITA 1962.

[986] *Silke on South African Income Tax, op cit*, §13.2.

[987] §11(e) ITA 1962; *Silke on South African Income Tax, op cit*, §8.117.

costs[989] are discountenanced. These incentives are restricted to certain assets which do not enjoy other incentives.[990] However, there are special provisions providing exceptions, for instance, in respect of qualifying foundation or supporting structures.[991]

Further general capital allowances apply for items of movable **machinery, plant, implements and other utensils** used in manufacturing or similar processes. These apply on a straight-line basis at 20% per annum over 5 years[992] or 33.3% par annum over 3 years,[993] or indeed, at 40:20:20:20 rates over 4 years[994] (depending on when the asset was acquired).[995]

Industrial buildings acquired for use wholly or mainly[996] in manufacturing and similar processes would be eligible for annual building allowances of 2%,[997] 5%[998] or 10%[999] on the cost of acquisition and enhancements of the industrial capacity of such facilities (depending on the timing of the building or improvement works).[1000] These allowances enure to the benefit of a taxpayer

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988 Although formerly, this was on a reducing/diminishing-balance basis: see Practice Notes 19 (GN 707 *GG* 14756 of 30 April 1993) and 39(GN 375 *GG* 16415 of 19 May 1995).

989 Special anti-avoidance rules apply for transactions between connected persons: §11(e)(vii) ITA 1962.

990 As such, buildings, structures, works of a permanent nature, ships and aircraft are excluded: §11(e)(ii),(iii) *ibid.*

991 §11(e)(iiA) *ibid.*

992 For new or used qualifying assets acquired on or after 21 June 1993.

993 For new/unused machinery and plant acquired between 1 July 1996 and 30 September 1999.

994 For new/unused machinery and plant acquired on or after 1 March 2002.

995 §12C ITA 1962. Other provisions are applicable at rates of 50:30:20 over 3 years to assets acquired on or after 1 January 1989 (but presumably before 1 March 2002): *Silke on South African Income Tax*, *op cit*, §§8.38A,8.39-8.39BA.

996 Essentially, SARS requires that at least 50% of the floor space or the volume of the building should be used for qualifying manufacturing purposes: see further *Silke on South African Income Tax*, *op cit*, §8.17A; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, p.128.

997 For building or improvement works commenced on or after 31 December 1988.

998 For building or improvement works commenced on or after 1 January 1989 but before 1 July 1996; or on or after 1 October 1999.

999 For building or improvement works commenced between 1 July 1996 but before 1 October 1999, provided the completed works were brought into use by 31 March 2000.

1000 §13 ITA 1962.

provided a manufacturing or similar use dominates and any qualifying non-manufacturing buildings are constructed simultaneously.[1001]

4.2.5.4. Incentives for Innovation

Prior to 2 November 2006, the quest for new and innovative processes, products and designs was encouraged by tax incentives for **research and development** (**R&D**),[1002] particularly for 'R&D'[1003] aimed at the creation of 'intangible assets'.[1004] South African tax law departs from the accounting treatment (which distinguishes between 'research' and 'development' expenses),[1005] permitting the **full deduction**[1006] of all **revenue** R&D expenditure while expenses of a **capital** nature may be entitled to special depreciation by way of tax allowances. R&D expenditure on **revenue** account was tax deductible in the year actually incurred if undertaken by or on behalf of taxpayers for devising, developing, creating or (in some cases) registering rights to inventions and patents,[1007] designs[1008] and copyrights (other than trademarks)[1009].[1010] Conversely, certified[1011] **capital expenditure** could be deducted by writing off such costs[1012] over 4 years at rates of 40:20:20:20. Assets had to be exclusively used for R&D activities to be eligible. However,

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1001 However, while facilities used for only part of a tax year benefit from full annual allowances, interest and finance charges are excluded in calculating the base cost: *Silke on South African Income Tax*, *op cit*, §8.18.

1002 *Ibid*, §8.89A.

1003 'R&D' is defined as R&D actually or potentially resulting in intangible assets as contemplated under South African GAAP (but exclusive of R&D for social sciences, humanities, management and marketing): §11B ITA 1962.

1004 The Accounting Practices Board's **AC129** defines (1) '*assets*' as resources controlled by enterprises as a result of past events and from which future economic benefits are expected to flow and (2) '*intangible assets*' as identifiable non-monetary assets without physical substance held for use in the production or supply of goods and services, for rental to others, or for administrative purposes.

1005 Under AC129, 'research' expenditure should be expensed in the accounts while 'development' expenditure should be capitalised provided the intangible assets to which they relate to may be used or sold.

1006 Proposals are for 150% enhanced deductions: SA Budget Speech 2006, *op cit*, p.18.

1007 Defined by the *Patents Act 57 of 1978*.

1008 Defined by the *Designs Act 195 of 1993*.

1009 Defined by the *Copyright Act 98 of 1978*.

1010 §11B(2) ITA 1962.

1011 By the Council for Scientific and Industrial Research.

1012 Being the lesser of (x) actual cost, (y) equivalent costs if acquired on an arms-length basis and (z) cost to connected persons from which the assets were acquired.

for buildings, apportionment provisions permit partial deductions where some of the facilities are used for non-R&D purposes. The dates on which assets were put to use are immaterial provided that some use was made during the relevant tax year. Similarly, there are no claw-back provisions for tax deductions enjoyed in previous years where the R&D activities are discontinued.[1013]

Since 2 November 2006, taxpayers may access new R&D incentives in terms of §11D, ITA 1962 which introduced an incentive regime similar to that operative under §11B.[1014] In the main, the new provisions permit the **immediate deduction of operating expenses at 150%**. Accelerated deductions for **capital expenditure** may be made over a shorter period of 3 years at rates of **50:30:20**.[1015] To qualify for the new R&D deductions, the R&D activities must be undertaken within the Republic and directed towards the advancement of novel, practical and non-obvious information regarding inventions, designs, computer programmes and other scientific or technical knowledge. Buildings and facilities must be regularly utilised and specifically equipped for research purposes to qualify for the deductions.[1016] Expenditure for certain related activities which do not qualify under the definition of R&D are disallowed. These include prospecting for minerals, oil and gas; the management or enhancement of internal business processes; trademark creation; social science or humanities research; and marketing, sales and market research.[1017] However, as seen below in **§7.3.2.5**, some aspects of the new provisions are fraught with difficulty impairing the ability of investors to access the incentives.

1013 §11B(3) ITA 1962.
1014 Medium Term Budget Policy Statement 2006, *op cit*, p.50.
1015 §11D(1)&(2) *ibid.*
1016 §11D(4) *ibid.*
1017 §11D(5) *ibid.*

4.2.5.5. Incentives for Qualifying Strategic Industrial Projects[1018]

A key aspect of South African tax incentive policy are special incentives targeted at high value strategic industrial projects utilising certain industrial assets which have potential to increase economic growth or employment and positively impact the South African economy. This **industrial investment allowance** is a remarkably well-targeted tax incentive, with clear objectives, prudent administrative procedures and explicit tax expenditure limits.[1019] Eligible projects enjoy two levels of preferential tax treatment. For **normal** qualifying projects, incentives permit the deduction of 50% of the cost[1020] of qualifying industrial assets by way of **investment tax allowances**, capped at the lower of the amount of approved investment and R300million. For projects qualifying with **preferred status**, the investment tax allowances permit full (100%) deductibility capped at the lower the amount of approved investment and R600million.[1021] Further restrictions ring-fence the allowances to income derived from such industrial projects; however, any unused investment tax allowances may be carried forward indefinitely to succeeding years.[1022] Eligible assets include new or unused industrial machinery and plant, and buildings (or any improvements thereto) provided such machinery/plant or buildings are commissioned within four or three years,[1023] respectively, from the date of approval as a qualifying strategic industrial project.[1024] Special recoupment provisions claw-back some allowances enjoyed on early disposal of relevant assets.[1025]

1018 §12G *ibid*; *Silke on South African Income Tax*, *op cit*, §8.39F; Peter Surtees 'New Incentives Encourages Investment in South African Industrial Projects' TNI Jan 10, 2002 [2002 WTD 7-8].

1019 Set at an aggregate of R10billion worth of allowances by the Minister of Trade and Industry: §12G(6) ITA 1962; Budget Review 2001 at 216.

1020 Relevant costs relate to acquisition, erection, construction and other direct costs and include finance charges, related party premiums and government subsidies: §12G(1) ITA 1962.

1021 §12G(2) and (3)(b) *ibid.*

1022 §12G(3)(a) *ibid.*

1023 However, where industrial assets costing more than R1billion are involved, the four year period may be extended by another year at the discretion of the *Minister of Trade and Industry*: §12G(16)(a) *ibid.*

1024 §12G(1) and (2) *ibid.*

1025 §8(4)(n) *ibid.*

Sponsoring companies (and any connected persons) must be registered taxpayers in good standing as evidenced by certain documents to this effect.[1026] To be eligible, projects must first (x) qualify as strategic industrial projects, then (y) meet certain basic minimum criteria, and finally (z) be so highly-rated based on a points-scoring system as to satisfy the Minister of Trade and Industry (as advised by a special adjudication committee)[1027] as to the project's potential to increase growth or employment within the Republic. To qualify as 'strategic' and 'industrial', projects must be associated with key manufacturing, computer-related or R&D activities. The types of projects falling within the latter two categories are determined in accordance to certain regulations.[1028] For instance, eligible manufacturing activities must be classified as 'Major Division 3: Manufacturing'.[1029] Eligible manufacturing activities cover a host of industries including manufacturing and processing of food and beverages;[1030] manufacturing and processing of clothing and textiles;[1031] manufacturing wood and paper products; publishing, printing and reproduction of recorded media; manufacturing, processing and refining coke, petroleum products, nuclear fuel, basic chemicals and other chemical products; manufacturing certain man-made products;[1032] manufacturing basic metals, iron, steel, precious and non-ferrous metals; manufacturing and casting metals products; manufacturing general and special purpose machinery[1033] and electric apparatus;[1034] manufacturing radio,

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[1026] The documents required are a declaration and certificate from the Commissioner for Taxes stating, respectively, that (a) the persons are taxpayers of good standing and (b) they are registered for tax purposes and their tax affairs are up to date. The Commissioner must inform the Minister of Trade and Industry if a company's request for such documents is refused: §12(10)(c) *ibid.*

[1027] The committee is composed by three special representatives each of the Department of Trade and Industry and the SARS/National Treasury reflecting both investment promotion and revenue interests: §12G(14) *ibid.*

[1028] Such regulations are made by the Minister of Trade and Industry on consultation with the Minister of Finance.

[1029] In Statistics South Africa's most recent standard Industrial Classification.

[1030] Including meats, fish, fruits, vegetables, oils and fats, dairy products, grains, starches and animal feeds.

[1031] Including leather, fabrics, furs, footwear and other articles of apparel.

[1032] Including man-made fibres, rubber products, plastic products, non-metallic mineral products, glass and glass products.

[1033] Including household appliances, office, accounting and computer machinery.

[1034] Including electric motors, generators and transformers, electrical control and distribution apparatus, insulated wire and cable, accumulators, primary cells and batteries, electric lamps and lighting equipment.

television, telecommunication and other equipment;[1035] manufacturing transport vehicles, equipment and spares;[1036] and the manufacture of jewellery, toys, games and recycled waste/scrap materials.

The basic, **minimum criteria** target long term and viable industrial projects by taxpayers in good standing which: involve the introduction of assets in excess of R50million within a 4 or 3-year post-approval horizon; if new, increase production and employment in the relevant sector:[1037] if not novel, significantly increase the capacity of existing projects; and do not qualify for certain other benefits or concurrent investment incentives.[1038] The **second stage approval** by the Minister of Trade and Industry[1039] evaluates the extent to which proposed projects would upgrade the relevant industry,[1040] provide general business linkages,[1041] and create direct or indirect employment.[1042] Finally, the achievement of **preferred status** with additional incentives is dependent on the project's total points score (*see Table 4.1*).

1035 Including medical, optical/photographic and precision equipment.
1036 Inclusive of motor vehicle, railway, aircraft /spacecraft, and marine equipment.
1037 After due allowance has been made for displacement in that sector.
1038 Such as the tax holiday scheme or benefits available to value-added processes: §37(H),(E) ITA 1962.
1039 As advised by the adjudication committee.
1040 By applying new processes or supplying new products; serving as key component to increase the competitiveness of existing industrial sectors; or engaging in value-added processes.
1041 With small, medium and micro-enterprises supplying the projects with goods and services; or by providing publicly available infrastructure.
1042 §12G(5) ITA 1962.

TABLE 4.1

SOUTH AFRICAN STRATEGIC INDUSTRIAL PROJECT POINT SYSTEM

Factor	*Points*
A. Upgrading industry	
i. New product or process	1 point
ii. Key component of a cluster	1 point
iii. Value-added process	1 point
B. Business linkages	
i. SMME purchases	10% of total purchases = 1 point
ii. Infrastructure (5% of the cost of the investment)	20% of total purchases = 1 point
C. Direct and indirect employment creation	
i. Job creation	3 full time jobs per R1million of qualifying assets = 1 point 4 full time jobs per R1million of qualifying assets = 2 points 5 full time jobs per R1million of qualifying assets = 3 points 6 full time jobs per R1million of qualifying assets = 4 points

Qualifying strategic industrial projects which score 4 points are eligible for the special investment tax allowances and those scoring 6 points enjoy preferred status. The creation of direct and indirect employment ranks high in the scheme of things as may be deduced from the relevant weights attached to criteria. There are detailed procedures specifying annual reporting requirements which benefiting companies and relevant functionaries must adhere to. These regulations ensure that only deserving projects that produce tangible results continue to benefit from the incentives.[1043] Administrative personnel must strictly observe confidentiality rules given the detailed private and technical information that must be disclosed by applying companies regarding their projects.[1044] The incentives may be withdrawn under certain claw-back rules where obtained using fraudulent, incomplete or inaccurate information. Depending on the level of culpability involved, companies may be liable, on the withdrawal of incentives to additional assessments and penalties.[1045]

These special incentives for strategic industrial projects are one way in which tax policy seeks to promote industrial innovation, growth and development. While the programme attracted billions of rands in investment it appears that the primary objective of generating significant employment opportunities was not achieved. Consequently the programme was phased out in July 2005.[1046] The next section considers similar incentives targeted at value-added processes.

4.2.5.6. **Incentives for Value-added Processes**[1047]

Special provisions provided tax incentives targeted at approved beneficiation or 'value-added processes' by which raw materials or intermediate products are processed to yield intermediate or final products. Such processes would qualify as sufficiently value-adding if they: add at least 35% of value-added to raw materials or intermediate products, based on a specific value-added formula;[1048] are being carried on an internationally competitive scale; and utilise foreign term credits for the importation of any imported capital goods.[1049] The incentive extended tax deductibility rules in respect of pre-production interest/finance charges,[1050] qualifying industrial buildings,[1051] machinery and

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1043 §12G(8),(16) and (17) ITA 1962.
1044 §12G(18),(19) *ibid.*
1045 §12G(9),(10),(11) and (20) *ibid.*
1046 Budget Review 2005, *op cit*, p.83.
1047 §37E ITA 1962; *Silke on South African Income Tax*, *op cit*, §8.115B.
1048 The formula is **(A – (B + C)) ÷ A x 100 ÷ 1**: where A is the ex-factory price of the intermediate or final product; B is the input cost of raw materials/intermediate products; and C is the cost of electricity consumed in the production.
1049 §37E(1) ITA 1962.
1050 §11(bA) *ibid.*

plant[1052] to expenditures related to such value-added processes by relaxing the rules normally relating to these tax deductions.[1053]

Eligible processes had to be approved by a special value-added committee which is appointed by the Minister of Finance[1054] and carried out certain regulatory duties.[1055] The committee's terms of reference were quite wide and include the evaluation of the scheme's effect of the scheme on the Exchequer as well as a consideration of the degree to which (x) production of an intermediate product will promote further processing of that intermediate product by other industries in the SACU; (y) preference will be given to local SACU products; and (z) SACU SMEs would be affected by the process.[1056]

The scheme was a rather controversial attempt at promoting intermediate processing of goods and attracted De Koker's criticism that its provisions are merely an attempt at handing out concessions 'to a favoured few at the expense of the fiscally disenfranchised many'.[1057] One particularly unusual provision permits any excess of cumulative allowances over taxable income resulting in new or increased assessable tax losses to be converted into unique 'negotiable tax credit certificates', which may be then disposed of to other taxpayers and used by them in meeting their normal tax, secondary tax and provisional tax liabilities at the expense of the National Revenue Fund.[1058] It is not clear how these provisions could directly promote the proliferation of these value-added processes but it would appear to lend credence to the views of commentators like De Koker's. However, these tax incentives have been since phased-out and

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1051 §13(1) *ibid.*
1052 §12C *ibid.*
1053 The key modification is that eligible assets may qualify before their acquisition or construction, provided they are commissioned within certain time periods: §35E(5) and (6) ITA 1962.
1054 In concurrence with the Minister of Trade and Industry.
1055 §37E(2) ITA 1962. The committee is also charged with excluding benefiting processes from enjoying other forms of state assistance.
1056 §37E(3) *ibid.*
1057 *Silke on South African Income Tax*, *op cit*, p.8-314-5.
1058 §37E(9)-(12) *ibid.*

taxpayers have until 29 February 2008 to use any outstanding negotiable tax credit certificates.[1059]

The next section considers somewhat less controversial incentives targeted at Small, Medium and Micro-Enterprises (hereafter: SMMEs).

4.2.6. MICRO-ENTERPRISES & BLACK ECONOMIC EMPOWERMENT

4.2.6.1. Overview

An abiding legacy of *apartheid* is the large income inequity existing predominantly across racial lines due to the restricted access of historically disadvantaged groups to wealth, skills, jobs, educational opportunities and the economy in general. These problems manifest in current high unemployment rates[1060] fuelling poverty, conflict and crime. Post-*apartheid* policies seek to redress the injustices inflicted on these groups.[1061] In the main, such policies coalesce around the Black Economic Empowerment (hereafter: BEE) Strategy[1062] as an ongoing part of the 1994 Reconstruction and Development Programme. BEE promotes wider economic participation by encouraging black-owned and controlled businesses, more blacks in executive and senior management positions, more women in business, industry and public institutions, and the growth of SMMEs and entrepreneurship. BEE adopts various strategies[1063] to achieve these ends. Specific tools include balanced

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1059 SARS Budget Tax Proposals 2007/8, pp.24-25.

1060 Estimates for unemployment vary from 26% to 41% despite the increasing role of social-grants and the Expanded Public Works Programme to alleviate poverty: OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p.476.

1061 Blacks, women, youths and disabled persons.

1062 BEE is described as 'an integrated and coherent socio-economic process that directly contributes to the economic transformation of South Africa and brings about significant increases in the numbers of black people that manage, own and control the country's economy, as well as significant decreases in income inequalities': Department of Trade and Industry, *South Africa's Economic Transformation: A Strategy for Broad-Based Black Economic Empowerment* (DTI) March 2003, p.12.

1063 *Viz.*, legislation, regulation, restructuring of state-owned enterprises, preferential public procurement, partnerships with the private sector, sectoral and enterprise-based charters and institutional support (from BEE Commission and Advisory Council, Industrial Development Corporation, and National Economic Development and Labour Council).

score-cards, [1064] financial initiatives (state-facilitated finance, venture capital/project financing, grants) and fiscal incentives. While some of these non-tax incentives shall be considered anon, the next section briefly highlights some tax incentives targeted at SMMEs.

4.2.6.2. Tax Incentives for SMMEs

Direct fiscal support by way of incentives for BEE transactions never materialised due to concerns over the potential for undesirable economic distortions.[1065] **Robyn Nathan** pointed out that one possible exception to this rule is the relaxation of the 75% share ownership threshold required to qualify for group recognition and relief.[1066] As **Rendani Neluvhalani** explained, if a parent company's share holding in a related subsidiary fell below 75%, it would lose the benefit of group relief rules. Most BEE deals however, required a 30% stake to be sold to the BEE investors. To promote BEE deals and prevent companies engaging in these deals from losing the group relief benefits, this threshold was reduced from 75% to 70% to satisfy both BEE and group relief thresholds. [1067] Recent fiscal policies propose measures to prevent tax implications for artificial gains and losses arising out of BEE transactions involving cross-issue of shares and forced share buy-backs. However, under-utilised provisions permitting the tax-free acquisition of shares under (BEE) employee share ownership schemes are to be revised.[1068] Microenterprises are to continue to benefit from lower thresholds for income tax, capital gains tax, bespoke depreciation regimes and measures to reduce tax compliance costs. A turnover tax is to be introduced in fiscal year 2008 which microenterprises may

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[1064] These measure the performance of sectors and enterprises against certain criteria (namely, direct empowerment; human resource development/employment equity; and indirect empowerment targets) and are used by government bodies to grant licenses/concessions, sell assets and engage in public-private partnerships.

[1065] South Africa: Staff Report for the 2005 Article IV Consultation, IMF Country Report No 05/346, September 2005 (IMF, Washington D.C.: 2005), p.24.

[1066] Interview with Ferdi Vorster and Robyn Nathan, *op cit*; see also §§41-49, ITA 1962.

[1067] Budget Review 2005, *op cit*, p.84.

[1068] SARS Budget Tax Proposals 2007/8, pp.4-6.

opt into to avoid the complexities of normal tax and VAT.[1069] The threshold for VAT registration is also to be increased to R1million from R300,000.[1070]

However, certain indirect tax incentives are used to promote the growth of SMMEs. As a significant proportion of these SMMEs are managed by previously disadvantaged persons, tax concessions for SMMEs indirectly foster black indigenous participation in the economy. Small business corporations[1071] are liable for normal tax at a reduced rate of 10% on the first R300,000 of taxable income and the normal 29% (28%: FY 2008) rate on revenues in excess of this[1072].[1073] Small business corporations are also entitled to multiple deductions on certain capital expenditure. Eligible small business corporations are entitled to **full (100%) deductions** of the cost of capital manufacturing assets during the tax year such assets were first brought into use[1074] and **double (200%) deductions** of certain start up costs subject to a ceiling of R20,000.[1075]

Indirect tax incentives noted above include fiscal incentives for the value-added processes scheme and the qualifying strategic industrial projects. Both schemes feature elements which promote, respectively, SMMEs in the SACU region[1076] and the increased business linkages between larger enterprises and SMMEs supplying them with goods, services and inputs.[1077] Grants, subsidies and other state assistance provided under non-tax incentive schemes including

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1069 Budget Review 2008, p.63; SA 2008 Budget, p.21.
1070 Budget Review 2008, p.67.
1071 Defined as companies or close corporations, other than employment companies, wholly owned by individual shareholders (none of whom hold shares or interests in any other private company or close corporation during the relevant tax year), whose gross income do not exceed R14million p.a. (increased from R6million) and does not comprise of 20% or more of income from investments or personal services: §12E(4) ITA 1962.
1072 SA Budget Speech 2006, *op cit*, p.18.
1073 ¶2(b) of Schedule 1 of *Taxation Laws Amendment Act 16 of 2004* (for years of assessment ending within 12months of 31 March 2005 the rate was 15% on the first R150,000 of taxable income and 30% on the excess.
1074 For periods on or after 1 April 2001: §12E(1) ITA 1962.
1075 §12E(3A) *ibid.*
1076 §37E(3)*ibid.*
1077 §12G(5) *ibid.*

the Small/Medium Manufacturing Development Programme,[1078] the Small, Medium Enterprise Development Programme,[1079] the Export Credit Finance Guarantee Scheme for SMEs and the Small Business Development Corporation Limited are tax exempt.[1080]

The 2006 Budget proposed a tax amnesty programme to help SMME and other tax-evaders (such as taxi drivers and informal traders) regularise their tax positions upon the payment of a flat 10% tax on taxable incomes earned in the 2005 year of assessment[1081] operative between 1 August 2006 and 31 May 2007. The definition of small corporations was also relaxed for income tax purposes.[1082] Finally, financial transaction taxes (stamp duties) on debit entries were eliminated effective from 1 March 2005 to relieve the burden on small businesses and low income individuals at a cost of R350million to the fiscus.[1083] Numerous informal businesses and SMMEs are active in tourism; the next section examines tax incentive policy other sectors.

4.2.7. Other Services

4.2.7.1. Tourism

Tourism plays a significant role in the economy, contributing 8% to GDP. Visitors increased from 640,000 in 1994 to a record 6.7million in 2004.[1084] Tourists range from 'shopping safari' visitors from neighbouring African countries to European and American visitors on luxury cruises, golf packages and water sport tours. South Africa attracts millions of eco-tourists each year

[1078] This scheme provides cash incentives for investment in manufacturing, agro-allied, biotechnology, tourism and ICT business for eligible companies, close corporations, proprietorships and partnerships engaged in new or expanding investments in South Africa.
[1079] Effective from 1 September 2000.
[1080] §10(1)(zE) and (zH) ITA 1962.
[1081] SA Budget Speech 2006, *op cit*, p.17.
[1082] The income tax exemption threshold was increased from R35,000 to R40,000: Medium Term Budget Policy Statement 2006, *op cit*, p.45.
[1083] Budget Review 2005, *op cit*, p.85.
[1084] OECD/AfDB *African Economic Outlook 2005/06 – Country Studies: South Africa*, *op cit*, p. 463. However, declines in exports, rising labour costs and poor domestic demand

to visit its game parks, nature reserves and national parks including the famous Kruger and KwaZulu-Natal national parks. Tourism is promoted by individual cities and provinces under the supervision of South African Tourism. Work on transportation and other facilities are ongoing to enhance the local infrastructure ahead of the 2010 FIFA World Cup.[1085] R9billion is to be allocated to upgrading transportation infrastructure ahead of the World Cup.[1086] Recent proposals for **tax incentives for the 2010 FIFA World Cup** include: import tax exemptions for imported media equipment and pharmaceutical goods; VAT and income tax exemption for profits from souvenir items; and income tax exemptions for FIFA subsidiaries, non-resident FIFA officials and the Local Organising Committee.[1087]

Hotel keepers[1088] may benefit from capital allowances on the costs of hotel buildings and improvements thereto. Applicable rates vary from 2%[1089] and 5%[1090] to 20% on development costs, depending on certain criteria. Essentially, the former 2% rate was increased to a 5% rate which applies on the cost of developments commencing on or after 4 June 1988. The 5% rate was increased to 20% on relevant expenditure for improvements commenced on or after 17 March 1993 which do not extend the existing exterior framework of the building.[1091] However, the building expenditure must have been incurred by the hotel proprietor (or indeed, his lessee) and eligible buildings and

due to income disparities have adversely affected the sector: van Buren 'South Africa: Economy', *op cit,* p.1056.

1085 The World Cup is expected to generate R16.9billion of direct investment, create 122,800 jobs, attract 400,000 visitors and increase tax collections by R5.6billion: see Colin Bryden 'South Africa's Winning Bid', *Phambili SA* Edition 3, October/November 2004, WriteStuff Publishing cc (Sandton, South Africa, October 2004) 6.

1086 SA 2007 Budget, p.19.

1087 Medium Term Budget Policy Statement 2006, *op cit*, p.54.

1088 Defined as persons carrying the business of hotel keeper or boarding or lodging house keeper where meals and sleeping accommodation are supplied to others for money: §1 ITA 1962. Lessors whose lessees are hotel keepers may benefit from the same incentives.

1089 Prior to 4 June 1988.

1090 With effect from 4 June 1988.

1091 §13*bis* ITA 1962.

improvements exclude acquired facilities.[1092] Some other capital allowances have been replaced under recent amendments.[1093] However, **wear-and-tear/depreciation allowances**[1094] are still applicable as are allowances for the **acquisition**[1095] and alienation, loss or **destruction**[1096] of hotel equipment.[1097]

4.2.7.2. Film and Entertainment

The entertainment industry in South Africa is varied and profitable, ranging from celebrated theatre, orchestral and dance troupes, to cultural festivals, music, fine arts and cultural crafts. Public investment in cultural tourism has been significant, with R35million (2001) and R12million (2003) committed to support orchestras and film development.[1098] Film development is a particularly lucrative sub-sector, with world-class facilities available to local and foreign producers alike. Public support for the film sector features in the use of tax incentives to encourage film production, development, marketing and exporting.[1099] Special tax provisions are made in respect of films and film owners.[1100] The general deduction formula may be utilised to deduct outlays for film acquisition, development and marketing provided these are incurred in the production of taxable income.[1101] **State subsidies** provided to producers of films are treated as exempt income for normal tax purposes.[1102]

Film producers/marketers may benefit from **special tax incentives** permitting tax deductibility of production or acquisition costs and post-production

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1092 *Silke on South African Income Tax*, *op cit*, §8.62; Badenhorst, *Taxation & Investment in South Africa*, *op cit*, p.128.
1093 See for instance the grading allowance for hotel buildings and improvements (under §13*bis*) and the 50:30:20 allowances (under §12B).
1094 §11(e) ITA 1962.
1095 §12C *ibid*.
1096 The equivalent of the 'scrapping allowance': §11(o) *ibid*.
1097 Hotel equipment, for the purposes of §12C, excludes any vehicle or equipment for offices or mangers' or servants' rooms: §12C(e) *ibid*.
1098 Pocket Guide to SA, *op cit*, pp.185-188.
1099 *Silke on South African Income Tax*, *op cit*, §§8.51 and 8.52; Badenhorst, *Taxation & Investment in South Africa*, ¶15.6 *op cit*, p.183.
1100 The definition of 'film' extends beyond cinematograph films, video tapes and discs to include copies of and rights in films: §24F(1) ITA 1962.
1101 §11 *ibid*.
1102 §24F and §10(1)(*z*G) *ibid*.

expenditure.[1103] The timing of the **film allowance** depends on when the relevant expenses were incurred in relation to the film's completion date. **Production costs**[1104] for uncompleted films may be carried forward and deducted in the year in which the completion date falls. If any **post-production costs**[1105] are incurred in this year, these too may be claimed. Subsequent post-production costs (and any unclaimed allowances carried forward) may only be claimed as incurred in subsequent years.[1106] There are separate provisions for allowances in respect of **print costs**[1107] **and marketing expenditure.**[1108] 'At risk' rules limit the scope of these allowances to sums expended by film owners out of their own financial resources and credits raised to meet such expenditure, provided that such obligations remain outstanding on the last day of the year of assessment. The essence of these 'at risk' rules is to limit incentives to economic risks that the film owners are actually exposed to should no income accrue to them from the subsequent exploitation of the film.[1109] In addition to the 'at risk' rules, tax allowances are generally restricted to actual production and other costs incurred.

1103 §24F *ibid.*

1104 The scope of such production costs is very wide and covers, *inter alia*, expenditure on the erection, construction or acquisition of buildings and other permanent structures; acquisition costs for story rights, script, screenplay, copyrights, other rights and music/sound effects; insurance premiums for policies relating to life, injury, accidental damage and cost over-runs insurance; finance costs and wear-and-tear depreciation.

1105 Production costs (except print costs for making copies) incurred after a film's completion date.

1106 §24F(3)(a) ITA 1962.

1107 Essentially costs incurred by film owners associated with making copies of films.

1108 This phrase includes research, advertising, publicity, and export-oriented expenses (provided export is to non-SACU countries).

1109 See 'Explanatory Memorandum on the Income Tax Bill, 1987' [WP3-'87] cited in *Silke on South African Income Tax*, *op cit.*

4.3. Conclusion

This Chapter highlights the historical and political development of the South African legal system, notes constitutional provisions for economic rights and summarises salient aspects of the South African fiscal system. It summarises the key characteristics of the Republic's tax incentives for various economic sectors, focussing on agriculture and food security, energy, power-generation and mining, financial services, physical infrastructure and basic services, manufacturing and industry, micro-enterprises and black economic empowerment initiatives, and other services like tourism and entertainment.

Numerous tax incentives are used to promote employment, productivity, economic growth and the provision of basic infrastructure and services to all South African citizens in line with GEAR's overarching policies. Due to the nature of the South African tax system, tax credits rarely feature and the most common tax incentives are tax deductions by way of investment tax allowances. Deductions may be applied in terms of the general deduction formula or more specific capital allowances for particular capex outlays. Certain incomes are tax exempt and are ignored or deducted in arriving at taxable income.

Less sophisticated incentives like tax holidays are being phased out and replaced by more carefully targeted schemes like the special deductions for qualifying strategic industrial projects. The revenue cost and redundancy rates of these incentives are limited by ring-fencing restrictions, claw-back provisions and anti-avoidance rules. Tax administration is quite sophisticated compared to what obtains elsewhere on the continent. Taxpayer compliance is high and the resultant rising tax revenues give the National Treasury and Minister of Finance greater latitude in reducing tax burdens and providing more tax breaks for vulnerable groups and special sectors. Tax incentives have also given way to non-tax financial incentives utilising explicit subsidies and grants to achieve similar objectives in, perhaps, more transparent and effective ways. Early forms of these financial incentives were the Regional Industrial Development incentives and grants introduced in 1991 to lure companies and close corporations away from the denser industrial centres and promote news industrial areas. Modern forms of non-tax and tariff-based incentives increasingly feature in the fiscal environment. This Chapter continues the review of tax incentive systems in the study countries. Chapter 5 concludes this review, focussing on the Kenyan experiences with fiscal incentives for sustainable economic development.

5. A REVIEW OF KENYAN TAX INCENTIVES

"It is important to nurture any new ideas and initiatives which can make a difference for Africa."[1110]

5.0. INTRODUCTION

5.0.1. Proem

This Chapter reviews tax and investment incentive policy in the Republic of Kenya. Although this Chapter is largely based on bibliographical research, practical insights into the role of tax incentives within contemporary Kenyan fiscal policy were obtained from numerous discussions with Kenyan tax practitioners. Using the sectoral approach adopted in preceding Chapters 3 and 4, this Chapter highlights fiscal incentives utilised to promote investment, employment and economic growth in Kenya and so concludes the review of investment tax incentives in the three study countries.

1110 Quote attributed to Wangari Maathai, 2004 Nobel Peace Prize Laureate and founder of the Green Belt Movement which has mobilised poor women to plant 30million trees for over 30 years.

5.0.2. Historical Development of the Kenyan Legal System

5.0.2.1. Historical and Political Development[1111]

Kenya has historically been the trading and commercial centre of East Africa. Indeed, archeological evidence lends credence to the view that Kenya might be the cradle of ancient human civilisation.[1112] More modern inhabitants of Kenya trace their origins to the continuous influx of agrarian Bantu people from central Africa, migrant settlers from northern and western Africa, and coastal descendents of racial intercourse between Bantus and Omani Arabs.

The arrival of European traders and settlers[1113] threatened and eventually displaced Arabian control of Kenya's trading coast. The founding of the British East African Protectorate in 1895[1114] led to the arrival of British settlers in the late 1800s. The completion of the Uganda Railway in 1901 by indentured Asian labour was a key development linking the coastal port of Mombasa through the Kenyan hinterland to Kisumu on Lake Victoria. The railway was crucial in bringing the indigenous Kikuyu and Maasai into closer contact with the British colonialists, and introducing thousands of Indian labourers, traders and artisans whose descendants now constitute the Asian minority.[1115]

British colonial rule generally restricted indigenous African communities to native reserves while extending private European ownership of scarce arable lands particularly in the 'white highlands'.[1116] A racially stratified economy emerged with the Europeans dominating agriculture, administration and the economy; Asians serving as clerks, artisans and traders; and indigenous

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1111 See generally 'Kenya: Recent History' by Alan Rake and 'Kenya: Economy' by Linda van Buren in *Africa South of the Sahara* 2005, *op* cit, pp.573-583.

1112 Richard E. Leakey and Roger Lewin *People of the Lake: Mankind and Its Beginnings* (Avon Books, New York: 1979).

1113 The Portuguese in the 16th century and the British in the 19th century.

1114 Pursuant to the spheres of influence agreed among the European imperial powers at the Conference of Berlin, in 1885. The Protectorate covered the regions of contemporary Kenya and Uganda.

1115 Norman Miller and Rodger Yeager *Kenya: the Quest for Prosperity* (Westview Press, Colorado: 1994), pp.10-15; Paul Collier and Deepak Lal *Labour and Poverty in Kenya: 1900-1980* (Oxford University Press, New York: 1986), p.38.

1116 Under the *East African (Land) Ordinance* and the *Crown Land Ordinance of 1915*: see Miller and Yeager, *Kenya: the Quest for Prosperity, op cit*, p.15.

Africans engaged in agricultural labour and petty trade. The economic relegation of Africans into the informal, subsistence economy became a source of tension, further exacerbated by the post-World War I recession, unemployment and overcrowding of native reserves. Conflicts grew between the colonial administration's trusteeship duties to natives and the European settlers' interests in maintaining access to cheap African labour. The 1932 Carter Commission went some way in returning parcels of land to African communities. However, it was only after decades of increasingly violent political agitation[1117] that greater racial equity[1118] and ultimately independence[1119] were attained under majority African rule.

Of the various indigenous parties formed in the years preceding independence, the Kenya Africa National Union (hereafter: KANU) led by a Kikuyu, Jomo Kenyatta,[1120] eventually won early elections paving the way for subsequent one-party rule under Kenyatta's successor, Daniel arap Moi (a minority Kalenjin). Under Moi's 24 year rule, Kenya enjoyed a period of relative though uneasy political stability.[1121] During this period Africans were gradually integrated into the formal, European-style economy.

The traditional dominance of the majority Kikuyu, Luhya and Luo ethnic groups has been mitigated by the emergence smaller groups (notably the Kalenjin, Meru, Kamba and Gusii) in politics and the economy. However, despite accounting for a small fraction of the population, the minority Asian,

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1117 Notably the Kikuyu-led Mau Mau revolt of the 1950s involving the destruction of European and loyalist African property and farms, civil unrest and murders. The British responded with force and eventually suppressed the movement through arresting African leaders, a state of emergency, military action and the repatriations of whole communities: *ibid*, pp.24-26.

1118 The 1955 Swynnerton Plan addressed inequities of land use by providing Africans with opportunities for individual freehold ownership, farming credit, agricultural technical assistance and other inputs: *ibid*, p.26.

1119 On the 12th of December 1963.

1120 Kenyatta was an early pro-independence activist who was arrested in 1953 for being connected with the Mau Mau. He was later released from detention by the British colonial authorities in 1959 ahead of independence in 1963.

1121 However, Moi's rule was marred by a quashed coup (in 1982), political assassinations, the introduction of a constitutional one-party state system, repression of political opposition, civil rights abuses and public corruption.

Arab and European communities continue to control significant private sector interests. Local political agitation and international pressure (from donor agencies and creditors) led to the return to a multi-party system in the early 1990s. Ultimately, four decades of continuous single-party KANU rule was terminated in 2002 when the National Rainbow Coalition (hereafter: NARC) won the general elections and its leader, Mwai Kibaki,[1122] assumed power as President. However, the recent disputed Presidential elections of 27 December 2007 which returned Kibaki for another 5-year term has sparked an outbreak of violence and ethnic tension which has threatened Kenya's relatively stable democracy.

5.0.2.2. The Constitution & Economic Rights[1123]

The Kenyan legal system applies received English common law, doctrines of equity and statutes of general application in force in the UK on 12 August 1897. English common law governs commercial transactions, agency, contract, tortuous liability and the operation of trusts. Customary and Islamic law principles apply to a limited extent in respect of individuals. However, the Constitution of Kenya (hereafter: 1963 Constitution) remains the supreme law of the land. The parliamentary system inherited at independence eventually gave way to republican constitutional rule. The 1963 Constitution currently provides a republican framework composed of a dominant executive,[1124] the Parliament,[1125] and the judiciary.[1126] Kenya is divided administratively into 7 provinces and an area.[1127]

1122 Kibaki served as finance minister under Kenyatta and vice-president under Moi. He left the ruling KANU party to join the opposition.

1123 See Van Buren 'Kenya: Economy,' *op cit*, pp.573-583.

1124 The *Utawala*, headed by the President, whose numerous powers includes that of appointment of the Vice-President and Ministers, which together constitute the Cabinet: §17; Chapter 2, 1963 Constitution.

1125 The *Bunge*, constituted by the President and the unicameral National Assembly, the latter composed of elected members and 12 persons nominated by the President: §§31-32; Chapter 3, 1963 Constitution.

1126 The *Mahakama*, which includes the Court of Appeal, High Courts, and Kadhis courts: Chapter 5, 1963 Constitution.

1127 *Viz*, the Central, Coast, Eastern, North Eastern, Nyanza, Rift Valley provinces and the Nairobi Area.

The 1963 Constitution enshrines the underlying pro-capitalistic, free-enterprise principles on which the economy is based by guaranteeing rights to private property and specifically guarding against compulsory acquisition.[1128] Further investment protection assurances and guarantees against expropriation are contained in the *Investment Promotion Act of 2004*. A process of constitutional reform would have lead to a new draft constitution under which the enormous powers wielded by the President were to be devolved to a powerful Prime Minister. While there are hopes that a new political framework would provide a better foundation for good governance and political accountability than that under previous constitutional arrangements, it is unclear when these changes are to be adopted, given the present political crises and deep divisions over specific reforms.

1128 Except in certain instances, in the public interest and subject to judicial review and the payment of adequate compensation: §75, 1963 Constitution.

5.1. THE KENYAN TAX SYSTEM

5.1.0. Historical Development of Taxation in Kenya

The early incidence of taxation featured in the imposition of monetary hut and poll taxes on indigenous communities. Africans were compelled to shift from the subsistence, informal economy to wage-based, formal employment to obtain money to discharge these obligations.[1129] Hut and other taxes provided financial resources necessary to fund colonial administrative costs and redirected cheap human resources to sustain settlers' agriculture.[1130]

Taxes were originally administered by the colonial authorities of British East Africa – a region which included Uganda, Kenya, Zanzibar and Tanganyika (presently Tanzania). Upon the independence of these territories, tax administration was undertaken by the Income Tax Department of the East African Community.[1131] Concerns that Kenya benefited disproportionately from the common external tariff and absence of internal tariffs contributed to the eventual demise of the East African Community in 1973.[1132] The Kenyan government eventually assumed responsibility for the taxation of capital and incomes of taxable persons under the *Income Tax Act Cap 470 of 1973* (hereafter: ITA 1973). Until 1995, separate revenue departments administered income tax, customs and excise duties, and value added tax. Presently taxes are administered by the Kenya Revenue Authority.[1133]

5.1.1. Investing in Kenya

Successive Kenyan governments have consistently **promoted private investment** by both foreign and local investors though various policies. The Ministry of Trade and Industry implements investment promotion policy through its numerous departments. The erstwhile Investment Promotion

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1129 Collier and Lal, Labour and Poverty in Kenya: 1900-1980, *op cit*, pp.28-30.

1130 Miller and Yeager, *Kenya: the Quest for Prosperity*, *op cit*, pp.18-20.

1131 For Kenya, Tanzania and Uganda: Safdar Ali Butt and Amirali Sokwala *An Introduction to Taxation in Kenya* (Cassell, London: 1978), p.4.

1132 John F. Due *Taxation and Economic Development in Tropical Africa* (MIT Press, Cambridge-Massachusetts: 1963), pp.5,10,160.

1133 Samuel G. Kikira *Principles of Taxation Law in Kenya* (1st edition, Connectour Publishers, Nairobi: 1996) p.1.

Centre was re-constituted under the *Investment Promotion Act of 1994* as the Kenya Investment Authority possessing a wider remit to promote and facilitate domestic and foreign investment. Eligible investors are entitled to a special investment certificate which provides numerous benefits including the deemed grant of essential business licenses circumventing Kenya's extensive licensing regime.[1134] To be eligible, investors must demonstrate a potential positive impact on the economy in terms of increasing employment, upgrading skills, transferring technology or generating income. Foreign investors must meet a minimum investment threshold of US$500,000 (US$65,000 or KSh.5million is required for local investors) to be eligible for the certificate.

Exchange control laws and regulations were liberalised in 1994 resulting in the repeal of the *Exchange Control Act* in 1995. The Minister for Finance and the Central Bank regulate currency control and the activities of authorised dealers who trade in foreign exchange. Residents and non-residents may maintain foreign-currency denominated accounts with local banks. However, few regulations still exist and govern the application for forex allocations for imports.[1135]

Kenya is the leading economy in the resuscitated **East African Community** (hereafter: EAC). The Protocol establishing the EAC Customs Union (hereafter: EAC CU) took effect from 1 January 2005 and establishes a three band external tariff while abolishing internal tariffs on goods and services. EAC is one of numerous initiatives by which greater economic, political, social and cultural integration of the peoples of Kenya, Tanzania and Uganda is being secured.[1136]

1134 71 different licences may be required by investors: *Schedule to the Investment Promotion Act, 2004*; UNCTAD-ICC, *An Investment Guide to Kenya* (UN, New York/Geneva: 2005) [UNCTAD/ITE/IIA/2005/2], p.51.

1135 IBFD, African Taxation Systems: Kenya (IBFD, Amsterdam: 2005), p.xi.

1136 UNCTAD-ICC, *An Investment Guide to East Africa* (UN, New York/Geneva: 2005) [UNCTAD/ITE/IIA/2005/4].

Kenya also belongs to the **Common Market for Eastern and Southern Africa** (hereafter: COMESA) which is the successor association to the pre-1994 Preferential Trade Area. Among its 20-odd member nations,[1137] COMESA features a market of 374million consumers worth over US$92billion in annual trade, permits the free-flow of goods and services between member countries, and benefits from duty-free trade and economic cooperation between the EU and the wider association of African, Caribbean and Pacific States. Kenya is also a member of the World Trade Organisation.

Various forms of **business organisation** are normally utilised as investment vehicles. Typical business forms include unincorporated sole traders and partnerships, and incorporated cooperatives, building societies and companies. However, public and private registered companies are typically utilised by local and foreign investors. The incorporation, operation and dissolution of companies are governed by the *Companies Act*.[1138] Certain requirements must be met before the Registrar of Companies may issue a certificate of incorporation to the local or foreign promoters. For instance, every company must have a share capital of at least KSh20,000. However, companies may also have the liability of their members limited by guarantee or be unlimited. Private companies may have no less than 2 and no more than 50 members. Public companies must have at least 7 members.

Foreign investors may transact business through branch offices, subsidiaries or other places of business. Unincorporated branches of non-resident companies are exempt from the requirement to file audited accounts. However, these branches must be registered within 30 days of commencement of business with the Registrar of Companies. Wholly-owned subsidiaries of foreign companies are permitted although the government encourages joint ventures with

[1137] Besides Kenya, these include Angola, Burundi, the Comoros, the Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe.

[1138] Cap 486 of 1959.

indigenous businesses. Previous restrictions on the accessibility to local finance of wholly foreign owned subsidiaries have been phased out.[1139]

5.1.2. Taxing Powers, Tax Administration & Dispute Resolution

Taxing powers are generally concentrated in the central government with local governments deriving resources from property rates, grants and transfers from the central government. Local governments also levy services charges on employers and employees.[1140]

The main categories of tax are collected and administered by the central government through the Kenya Revenue Authority (hereafter: KRA). KRA was established in 1995 and is based in Nairobi. KRA is responsible for **tax administration**, revenue collection and enforcement of fiscal laws. Its roles also include combating tax evasion, reducing budget deficits by improving revenue collection and 'ensuring the protection of local industries and facilitating economic growth through the effective administration of tax laws relating to trade.'[1141] KRA is supervised by the Minister of Finance and headed by a Commissioner General who is himself assisted by Commissioners of Tax for Customs Services, Domestic Taxes, Road Transportation and Support Services.

Principal taxes include **direct** (mainly income) taxes and indirect taxes. Taxes on capital gains were suspended in June 1985 and estate duty was abolished in 1982. Proposals to **reintroduce capital gains taxes** on property other than road vehicles and marketable securities[1142] were postponed in 2007.[1143] Income tax is levied on individuals and companies at varying rates depending on **residence**. Taxable profits of resident companies are taxed at the prevailing

1139 IBFD, African Taxation Systems: Kenya, *op cit*, p.v.
1140 The rates depend on the collecting city, municipality or council: *ibid*, p.22.
1141 *Kenya Revenue Authority Act Cap. 469 of 1995.*
1142 Amos Kimunya: 'Speech Delivered to National Assembly on the 15th June, 2006 by Hon. Amos Kimunya, EGH, M.P., Minister for Finance, Republic of Kenya when presenting the Budget for Fiscal Year 2006/2007' (hereafter: K Budget Speech 2006), ¶129/p.30.

corporation tax rates (30%),[1144] while those of non-resident companies with permanent establishments [1145] are subject to income tax at higher rates (37.5%). [1146] Resident individuals are taxed at progressive rates [1147] on taxable income comprising gross income net of deductions for allowable expenses, personal relief and other allowances. Taxable income for this purpose includes business income from any trade, profession, vocation and employment income.

Taxable income from certain other specified sources are computed separately.[1148] Resident individuals are those possessing a permanent home in Kenya [1149] while resident companies are those incorporated or managed and controlled in Kenya.[1150] However, non-resident taxpayers are only taxable on a source basis applied to employment and other income derived from or accruing in Kenya.[1151] Withholding taxes apply on dividends, interest, rents, royalties and fees at varying rates (e.g. for dividends, a lower rate [5%] applies for Kenyan and EAC CU residents while a higher rate [10%] applies to non-EAC CU residents.[1152] For non-resident recipients, withholding tax may comprise the final tax on such receipts.[1153]

1143 Richard Harnley, 'Financial Markets: Regulation-Recent developments in banking and financial markets', [2007] J.I.B.L.R. N.39.

1144 §34 ITA 1973.

1145 Permanent establishments must constitute fixed places of business and are linked to a 6-months test of permanency: §2(1) ITA 1973.

1146 See Income Tax Chart: IBFD, African Taxation Systems: Kenya, *op cit*.

1147 These rates range from 10% to 30% for the highest band of income: *ibid*, p.12.

1148 These specified sources include rents from immovable property, income from self-employment and from agricultural activities: *ibid*, p.4.

1149 Or in the absence of such permanent home, are resident within Kenya for at least 183 days in any tax year or an average of 122 days in three consecutive tax years including the current tax year: §2(1) ITA 1973.

1150 Or deemed resident by an appropriate ministerial declaration.

1151 Based on the rates set by the relevant year's Budget: see §34 ITA 1973.

1152 Amos Kimunya: Budget Speech for the Fiscal Year 2007/2008 (1st July-30th June) by Hon. Amos Kimunya, EGH, M.P., Minister for Finance, Republic of Kenya on 14th June 2007 (hereafter: K Budget Speech 2007/2008), pp.28-29.

1153 IBFD, African Taxation Systems: Kenya, *op cit*, p.14.

The main **indirect taxes** include VAT, customs levies and excise duties. VAT is levied at a rate of 16% on taxable supplies of goods and services.[1154] The VAT net was extended in fiscal year 2007/2008 to include rentals from non-residential property.[1155] Excise duties are payable on manufactured goods including tobacco products, non-alcoholic drinks, alcoholic beverages, cosmetics and jewellery, motor vehicles, petroleum products and some services (mobile phone airtime).[1156] Rates of excise vary considerably from 10% for cosmetics to 145% for manufactured tobacco products.[1157] Similarly, tariffs for imported items vary depending on their nature. However, due to the EAC CU Protocol, a three-band common external tariff applies in Kenya, Tanzania and Uganda. Rates range from a maximum of 25% for finished goods through 10% (intermediate goods) and 0% (raw materials).[1158] Stamp duties apply on the execution of instruments relating to property or transactions performed in Kenya.[1159] Land taxes (property rates) are imposed by local government authorities at different rates depending on the relevant property's location.

International double taxation may be alleviated by the grant of *treaty relief* in the terms of any applicable double tax treaties or possibly, by *unilateral relief* through the deduction of foreign taxes from the tax liability assessed in Kenya, but only to the extent that such foreign taxes have actually been paid and are related to income derived in Kenya.[1160] Kenya has a relatively extensive network of double taxation treaties with its major trading partners including Austria, Bangladesh, Belgium, Canada, China, Denmark, France, Germany, Greece, India, Indonesia, Ireland, Japan, the Netherlands and the UK.[1161] Where such

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1154 The standard rate was reduced from 18% to 16% by the 2003/04 Budget. Certain goods and services are also exempt: see *Value Added Tax Act Cap. 476 of 2004* (hereafter: Kenyan VAT Act).

1155 K Budget Speech 2007/2008, p.31.

1156 Under the *Customs & Excise Act Cap. 476 of 1990.*

1157 IBFD, African Taxation Systems: Kenya, *op cit*, p.20.

1158 UNCTAD-ICC, *An Investment Guide to East Africa*, *op cit*, p.29.

1159 See *Stamp Duty Act 1958.*

1160 §§41 & 42, ITA 1973.

1161 Table IV.1 'Double Taxation Treaties (DTTs) and Bilateral Investment Treaties (BITs), with Signing Dates': UNCTAD-ICC, *An Investment Guide to Kenya*, *op cit*, p.51; IBFD, African Taxation Systems: Kenya, *op cit*, p.29.

treaties are in force their terms determine the applicable withholding taxes on dividends, interest, royalties and other receipts paid to eligible entities.

Kenya's **dispute resolution** system follows the adversarial tradition of the common law with a hierarchy of courts bound by judicial precedent and *stare decisis*. Dissatisfied taxpayers may object to decisions of the Commissioner of Tax, subject to the latter's right to amend or refuse to amend an assessment. If still dissatisfied, taxpayers may appeal against assessments to certain Tribunals or Local Committees.[1162] Appeals against decisions of Tribunals or Committees to the High Courts[1163] must be on point of law (or mixed law and fact).[1164] Appeals from the High Court on point of law or error of procedure lie to the Court of Appeal which is Kenya's apex court.[1165] Decisions of the Court of Appeal are final and binding on litigants.

5.1.3. Political Framework for Economic & Tax Policy

Since independence in 1963, Kenya has pursued a state-managed, free-enterprise economy. Despite high economic growth in the 1960s/1970s, outstanding public debt obligations increased from US$319million to US$4.8billion between 1970 and 1990 without corresponding increases in productivity, export earnings or private investment. To cope with these challenges, Kenya cultivated a structured dependence on high levels of debt and donor aid to meet budget deficits.[1166] It is unsurprising that in the face of public corruption, inefficiency and mismanagement, donor countries and multilateral lending institutions exert considerable influence on Kenyan monetary, financial and economic policies. Recent economic policy is best understood with an appreciation of this reality.

1162 §§82 & 89, ITA 1973.

1163 Established by §60, *1963 Constitution*: these are headed by a Chief Justice appointed by the President as advised by the Judicial Service Commission.

1164 §86 ITA 1973.

1165 §91A *ibid.* See also §64, *1963 Constitution* which establishes the Court of Appeal.

1166 Miller and Yeager, *Kenya: the Quest for Prosperity*, *op cit*, pp.152-157.

Donor intolerance with corruption and the Moi government's slow pace of reform came to a head with the suspension of multilateral aid from the IMF in 1997 and again in 2001. Aid resumed in November 2003 with the NARC government securing a US$252.75million Poverty Reduction Growth Facility (hereafter: PRGF) from the IMF to finance reforms proposed under the 2003-2007 Economic Recovery Strategy (hereafter: ERS)[1167].[1168] ERS revised and refined the 2001 Interim Poverty Reduction Strategy Paper and the NARC government's Manifesto and Post-Election Action Plan. ERS was financed by donor aid, domestic and external borrowing, and growth in private investment.[1169] Recent macro-economic policy has been based on ERS with a 2004/05-2006/07 Medium Term Expenditure Framework (MTEF) being used to link ERS objectives with outcomes under a Ministerial Public Expenditure Review (MPER) process. MPER was led by a National Steering Committee co-chaired by a Kenyan Permanent Secretary and the World Bank's Kenya Country Director. The Steering Committee's work was assisted by certain working groups and committees, and coordinated by the Ministries for Finance and Planning/National Development.[1170]

With the conclusion of the ERS in December 2007, economic development is to be sustained under the Vision 2030 programme which seeks to ensure Kenya is a more globally competitive and prosperous nation by 2030 by building on key economic, social and political principles.[1171] The rest of this Chapter considers existing and proposed fiscal incentives for Kenyan economic sectors.

[1167] ERS was the outcome of a consultative process facilitated by a National Investment Conference in November 2003 and a Donor Consultative Group meeting in January 2004: see International Monetary Fund, IMF Country Report No. 05/11 January 2005 Kenya: Poverty Reduction Strategy Paper/Investment Programme for the Economic Recovery Strategy for Wealth and Employment Creation 2003-2007 (rev'd March 12, 2004) (hereafter: IMF/Kenya: ERS 2003/2007).

[1168] Van Buren 'Kenya: Economy,' *op cit*, p.581.

[1169] US$4.1billion in donor aid was pledged at the January 2004 Donor Consultative Group meeting towards the ERS. Deficit financing is to be met by maximising external concessional borrowing while maintaining a declining external debt to GDP ratio of 36% and a domestic debt to GDP ratio reducing from 24.3% (2002/03) to 20.8% (2006/07): IMF/Kenya: ERS 2003/2007, pp.1-3,25-26.

[1170] IMF/Kenya: ERS 2003/2007, pp.5-7.

[1171] K Budget Speech 2007/2008.

5.2. Sectoral Tax Incentives

5.2.0. Introduction

This section reviews recent Kenyan tax incentive policy for various economic sectors. Key fiscal policy thrusts outlined by the Minister for Finance, **Amos Kimunya**, in his 2006 Budget Speech included directing financial resources to priority areas such as infrastructure development, health and education, agriculture and rural development; improving the environment for private investment; and creating employment. [1172] In Kimunya's 2007/2008 Budget Speech, greater emphasis was placed on promoting economic growth in 6 key sectors, namely: tourism, manufacturing, trade, business processing and financial services. [1173] He also outlined a raft of tax incentives and other measures to promote economic development in line with the broad objectives ERS/Vision 2030. These measures will be considered in the context of other fiscal incentives provided by Kenyan tax law for particular economic sectors.

Although Kenya's industrial and tourism sectors have contributed significantly to economic development in recent years, formal and subsistence agriculture has traditionally played the leading role, providing income and employment for the vast majority of Kenyans. The next section considers the use of tax incentives to promote economic development in the agricultural sector.

5.2.1. Agriculture & Food Security

5.2.1.1. Overview

While agriculture traditionally was the dominant economic sector contributing 25% of GDP in 2005, it has since been superseded by the services (tourism) sector which contributed 50% of GDP (2005). [1174] Recent growth in GDP has been erratic ranging from 2.7% (2003) to 1.4% (2004). The recent variability has been due to drought and depressed global prices for some agricultural commodities. [1175] However, growth improved to 5.5% (2005) and 5.4% (2006)

[1172] K Budget Speech 2006, pp.5-8.
[1173] K Budget Speech 2007/2008, p.14.
[1174] OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, pp.300,302.
[1175] OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, p.298.

largely due to improved rainfall.[1176] Kenya's mixed agrarian economy is broadly constituted by formal, export-oriented agriculture and informal, subsistence agriculture.

Export horticulture has been the leading sub-sector, recently utilising over 250,000 hectares of both plantations and smallholder farms, earning over US$600million annually from fruits, vegetables and cut flowers, and attracting substantial foreign investment. The UK and other European countries are major markets for horticultural produce including fruits, vegetables and floricultural products. The US market, however, remains largely untapped due to the dearth of direct flights from Kenya.[1177]

Coffee, tea and pyrethrum [1178] are also major cash crops, ranking after horticulture in recent years in contribution to employment, foreign exchange earnings and contributions to GDP. Although, **coffee** has historically been a key crop, recent output and proceeds have declined due to depressed international prices and smallholder producers switching to more profitable commodities. Since its introduction in 1903, [1179] **tea** has rapidly overtaken coffee in terms of production and exports.[1180] Tea production declined by 16% in 2005 but this was compensated by price increases of 11.2% despite a weakening US dollar.[1181] Tea production employs 10million Kenyans (or 10% of the population) and is divided between smallholder growers (with 60% of the market) and larger multinational plantations. In 2007, Pakistan, Egypt, the UK,

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1176 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, p.301.

1177 Studies indicate that great potential exists for expansion of the EU-15 and US markets in edible fruits and vegetables: UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.36.

1178 An aromatic plant which yields pyrethrin (a natural insecticide).

1179 By G.W.L. Caine, a European settler.

1180 Tea export values were US$440million (2003) contributing 24% of export earnings. Conversely, coffee exports declined from 11% to 5% between 1998 and 2003. Although deliveries increased by 87.7% in [the year to March 2003], low prices resulted in a mere 6% increase in export earnings to yield US$90million: UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.37; see also van Buren 'Kenya: Economy,' *op cit*, p.575.

1181 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*.

Afghanistan and the Sudan (respectively) ranked as the most popular destinations for Kenyan tea exports.[1182]

Kenya is the leading supplier of **pyrethrum** (a plant used to manufacture insecticide) supplying 70% of global demand and generating over US$25million per annum. The flower is cultivated by 200,000 smallholder families and marketed by the Kenyan Pyrethrum Board, providing income for over 1million Kenyans.[1183] Other keys sub-sectors include the production of sisal, cashew and macadamia nuts, livestock,[1184] dairy products, cane sugar, honey and fish. A recent UNCTAD study highlights significant investment opportunities in agriculture, particularly the upstream (processing), downstream (agricultural by-products) and services sectors.[1185]

Recent data indicates improving fortunes in agriculture. Despite a decline in tea production of 5.5% in 2006, increases in horticulture and coffee exports (2.2% and 6% respectively) contributed to a growth in real GDP of 6% in 2006.[1186] However, increased productivity is constrained by low precipitation during the short and long rains resulting in an acute shortage of arable, high-grade land.[1187] As such, agriculture is concentrated in the coastal, western and highland regions. Development of the larger expanses of arid and semi-arid lands in the north-east (hereafter: ASALs) has only recently become a priority.

In the past, a preference for (large-scale) production of export-oriented cash crops over (smallholder) cultivation for domestic consumption warped cultivation decisions resulting in structured dependency on food aid and

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[1182] Exports to these 5 countries accounted for 75% of total tea exports: 'Tea Industry Performance Highlights for 2007' by Sicily K. Kariuki, Managing Director, Kenya Tea Board.

[1183] See generally the Pyrethrum Board of Kenya's website at <http://www.kenya-pyrethrum.com/index.html>.

[1184] Including the processing of hides and leather.

[1185] UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, pp.35-39.

[1186] As opposed to 5.8% in 2005: see Central Bank of Kenya, Monthly Economic Review, February 2007, pp.15-17, available at <http://www.centralbank.go.ke/downloads/publications/mer/feb07.pdf>.

imports, particularly for key staples like maize and wheat.[1188] Structural and marketing problems emanate from inefficiencies of the marketing and auctioning boards responsible for sales of coffee, grains, sugar and cotton. Recent policies under ERS focus on promoting productivity to attain average annual growth of 5%.[1189] Fiscal initiatives to promote productivity and large-scale, mechanised activities in the sector are considered next.

5.2.1.2. **Tax Incentives**

Farmers[1190] are taxed on farming gains and profits inclusive of the difference between opening and closing stock values for livestock, produce and harvested crop.[1191] Special **capital allowances** apply at rates of 33.3:33.3:33.3 over 3 years,[1192] or indeed 50% over 2 years[1193] to deduct expenditure incurred on specified **farm works** from gross income. 'Farm works' include farmhouses, other immovable buildings, fences, drains, dips, water and electricity supply works but excludes machinery.[1194]

Agriculturists may also benefit from the immediate, **accelerated depreciation** of capex for clearing or planting permanent or semi-permanent crops[1195] and for preventing soil erosion, if incurred by the owner or tenant of agricultural land.[1196] In addition, there are other special capital allowances for items of agricultural equipment. Tractors, combine harvesters, heavy earth-moving equipment and other self-propelling machines weighing in excess of 7tonnes benefit from accelerated depreciation permitting associated capex to be

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1187 Only 20% of Kenya's irrigation potential has been tapped and a mere 7% of the land constitutes premium arable land: van Buren 'Kenya: Economy,' *op cit*, p.574.

1188 Miller and Yeager, *Kenya: the Quest for Prosperity*, *op cit*, pp.131-136.

1189 See IMF/Kenya: ERS 2003/2007, pp.55-58.

1190 Defined as persons carrying on pastoral, agricultural or other similar activities: §2(1) ITA 1973.

1191 §17, *ibid.*

1192 Or 20% p.a. over 5 years, if incurred prior to 1 January 1985.

1193 With effect from FY2006: K Budget Speech 2006, ¶135/p.31.

1194 ¶¶22 & 23, Second Schedule, ITA 1973.

1195 Traditionally, these categories have been restricted to cashew nuts, citrus, cloves, coffee, essential oils and New Zealand flax: Thirteenth Schedule, ITA 1973. However, the cultivation of avocadoes and mangos are to benefit from these provisions: K Budget Speech 2006, ¶135/p.31.

1196 IBFD, African Taxation Systems: Kenya, *op cit*, p.8.

expensed by 37.5% deductions applied to the written-down value of the assets.[1197]

Further tax incentives apply to indirect taxes. Numerous agricultural products, supplies and inputs are **wholly-exempted**[1198] or **zero-rated**[1199] for VAT. Many of these items are further exempt from customs duties.[1200] Import duties on sugar are suspended and other measures promote the importation of unprocessed oilseeds to promote the local processing industry.[1201] This proliferation of incentives is not surprising given the relatively greater importance of agriculture to Kenya than to the other countries examined in this Study. Although Kenya lacks the petroleum and mineral resource endowments of Nigeria and South Africa, some initiatives exist to promote the development of the Kenyan energy and mining sectors as noted the next section.

5.2.2. ENERGY & MINING

5.2.2.1. Energy, Power & Solid Minerals

Kenya has no significant **energy** reserves. However, prospecting for oil and gas reserves has been ongoing since the mid-1980s with the National Oil Company of Kenya and private concessionaires undertaking exploratory work in the Anza, Mandera, Tertiary Rift and Lamu sedimentary basins. The enabling legislation[1202] adopts the use of Production Sharing Contracts to provide incentives for developers. Despite these initiatives, no energy deposits of commercially viable quantities have been discovered underscoring Kenya's dependence on imported petroleum fuels. The refining of crude oil into

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[1197] Provisions are made for any resultant balancing charges or allowances: §7 ITA 1973.

[1198] Including numerous live animals and foodstuffs; frozen foods; bulbs, plants and seeds; and agricultural, animal husbandry and horticultural services: Second Schedule, Kenyan VAT Act.

[1199] Including vegetable seeds, pesticides, greenhouses, certain animal feeds, fertilizers and tea purchased at tea auction centres and insecticides: Fifth Schedule, Kenyan VAT Act.

[1200] IBFD, African Taxation Systems: Kenya, *op cit*, pp.18,20.

[1201] UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.40.

[1202] *Oil Exploration Act 1984/Petroleum (Exploration and Production) Act 1986.*

petroleum derivatives for the domestic market and the East African region occurs mainly at Kenya Petroleum Refinery Limited's Mombasa refinery.

Electrical power is generated locally from petroleum-fired plants, Olkaria geothermal stations and hydroelectric plants located in the Tana River Basin and Turkwel Gorge. However, as these local sources are unable to meet domestic power demands, Kenya imports 30MW from Uganda under a bulk supply contract and has concluded arrangements to connect its national grid to the South African Power Pool via Tanzania and Zambia. Recent energy projects funded by donor countries and multilateral lending agencies seek to complement local resources.[1203]

Recent policies promote increased private sector investment in geothermal, hydropower and oil-based thermal energy generation. These policies have resulted in the operation of four independent power producers (IPPs) which account for a fifth of local generative capacity. In the late 1990s, the state-owned power utility[1204] was reorganised and unbundled into a regulator,[1205] a generation company (KenGen)[1206] and a transmission and distribution company (KPLC).[1207] Despite these reforms, KPLC remains rather inefficient with high transmission and distribution losses, frequent blackouts and recurring financial losses. Its poor performance has adversely affected industrial productivity.[1208] However, recent data indicates an increase in electric power supply of 5.5% in 2006 (up to 5.823billion KWH) matching a 5.3% increase in electricity consumption (up to 4.743bilion KWH).[1209]

1203 E.g. the Japanese-sponsored Sondu-Miriu 60MW project and the World Bank's US$125million rural electrification project.
1204 Kenya Power Co.
1205 Electricity Regulatory Board.
1206 Kenya Electricity Generating Co. Ltd.
1207 Kenya Power & Lighting Co. Ltd.
1208 UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.41; van Buren 'Kenya: Economy,' *op cit*, p.578.
1209 CBK Monthly Economic Review, February 2007, p.18.

Although significant **mining** opportunities exist, much the potential of Kenya's four mining belts[1210] remains untapped. Soda ash is mined from the large, self-regenerative deposits of Lake Magadi. Soda ash is Kenya's principal export mineral with industrial applications in the manufacture of glass and paper products. Other mining sub-sectors have attracted foreign investment. For instance, the mineral sands project by a Canadian company (Tiomin Resources) at Kwale in the Coastal Belt should generate initial pre-tax cash-flows of US$40millon over the first 6years of an 11-year project lifespan. Tiomin forecasts substantial annual yields of zirconium and titanium.[1211] Other opportunities exist for the exploitation of gold, salt, vermiculite, limestone, rubies, apatite, graphite, kaolin, kyanite, topazes, and coal deposits.[1212]

The NARC government proposes certain policies designed to promote the energy and mining sectors. For **energy**, ERS proposes to: strengthen the regulatory role of the Electricity Regulatory Board particularly over tariff control, reduce the government's interest in KPCL from 51% to 39%, restructure KenGen as a public-private partnership and create a new Rural Electrification Authority.[1213] ERS appears not to specifically address **mining** activities. However, the NARC government has proposed changes to the Mining Act to generate revenue from coal and gold mining activities.[1214]

Tax incentives for the energy and mining sectors are reviewed next.

5.2.2.2. Tax Incentives

Power and mining companies are assessed to tax on the same basis as other businesses. However, petroleum companies operating under the *Petroleum*

[1210] *Viz.*, the Greenstone, Mozambique, Rift and Coastal Belts.
[1211] See generally Tiomin Resources' website at <http://www.tiomin.com/s/Home.asp> accessed on 15.02.2008.
[1212] UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, pp.17,44; van Buren 'Kenya: Economy,' *op cit*, p.578.
[1213] Further proposals seek to reduce the reliance on biomass as the principal source of domestic household energy to reduce associated environmental pollution and deforestation, and harness renewable energy sources such as solar energy and wind-power: IMF/Kenya: ERS 2003/2007, pp.55-58.
[1214] Van Buren 'Kenya: Economy,' *op cit*, p.578.

(Exploration & Production) Act 1984 are assessed to tax in terms of the Ninth Schedule, ITA 1973 on the basis of their production values less deductible allowances. Payments by petroleum companies to non-resident petroleum service subcontractors are subject to a withholding tax on profits deemed equivalent to 15% of taxable service fees.[1215] Finally, a tax on refining activities is applicable in terms of the *Refinery Throughput Act 1982* at 15% in respect of all sums charged by a refinery in connection with the refinery of crude petroleum.[1216]

There are relatively few incentives for economic activities in the energy and power sectors. Recent incentives include symbolic measures such as removing import duties on energy-saving bulbs [1217] and oil, fuel and air filters. [1218] Electrical power companies may benefit from **wear and tear deductions** permitting the deduction of 2.5% per annum of eligible capex over 40 years. Eligible capex here covers outlays for 'industrial buildings' including facilities for the generation, transformation, conversion, transmission or distribution of electrical power. [1219] Petroleum products, liquefied natural gas and power generating sets of certain specifications of output are **exempted from VAT**.[1220] **Losses** sustained by petroleum companies may be **carried back** up to 3 years against taxable profits upon cessation of business. [1221] Petroleum companies licensed under production sharing contracts may obtain **VAT remission** on imported capital goods including motor vehicles and aircrafts.[1222]

Mining activities enjoy more incentives than the energy/power sectors, possibly due to the greater potential this extractive sector has to generate revenues. Generous **capital allowances** permit the accelerated depreciation of qualifying capex. A **40% initial allowance** is granted in the first year, followed

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[1215] ¶9(1), Ninth Schedule, ITA 1973.
[1216] IBFD, African Taxation Systems: Kenya, *op cit*, p.25.
[1217] K Budget Speech 2006, ¶127/p.29.
[1218] *Ibid*, ¶152/p.34.
[1219] ¶5, Second Schedule, ITA 1973.
[1220] IBFD, African Taxation Systems: Kenya, *op cit*, p.18; First Schedule, Kenyan VAT Act.
[1221] IBFD, African Taxation Systems: Kenya, *op cit*, p.9.

by **annual deductions of 10%** over the next 6 years. Outlays may be expensed faster if the taxpayer can satisfy the Commissioner of Taxes that the economic life of the mine is less than 6 years. The scope of qualifying expenditure is quite wide and includes sums expended searching, winning and testing deposits; outlays to acquire rights over or access to deposits;[1223] and other costs intrinsically associated with mining activities. [1224] However, income and expenditure in respect of non-contiguous mines must be ring-fenced. [1225] Finally, expenditure incurred in respect of certain minerals may benefit from immediate expensing by **100% first year investment allowances**. This allowance operates in exclusion to the 40:10:10:10:10:10:10 allowances and only applies in respect of minerals specifically designated by the Minister for Finance.[1226]

Tax incentives to promote financial activities are reviewed in the next section.

5.2.3. FINANCIAL SERVICES

5.2.3.1. **Overview**

The Central Bank of Kenya (hereafter: CBK) is responsible to the Finance Minister for financial regulation and monetary policy. CBK implements monetary policy by targeting inflation, controlling reserve money and broad money supply, and engaging in open market operations. Exchange controls have been eliminated and the Kenyan Shilling trades freely against foreign with international currencies under a flexible exchange-rate system. [1227] Positive developments such as the IMF's endorsement of the NARC government's

[1222] §23, Kenyan VAT Act.
[1223] Provided these outlays are not site acquisition costs, processing expenditures or purchase consideration for rights acquired from a previous mine owner.
[1224] ¶¶16 & 17, Second Schedule, ITA 1973.
[1225] ¶19, *ibid.*
[1226] IBFD, African Taxation Systems: Kenya, *op cit*, p.8.
[1227] However, CBK periodically intervenes to reduce short-term exchange rate volatility.

economic policies in September 2004 have assisted the appreciation of the spot and forward rates for the Shilling.[1228]

The **banking** sector consists of 47-odd commercial banks, the top decile of which holds over 75% of depositors' funds.[1229] While commercial banks tend to be well capitalised, the prevalence of large portfolios of non-performing loans among state-owned banks belies the sector's apparent stability.[1230] **Insurance** institutions include 43-odd registered insurance companies and 197-odd brokers as well as numerous agencies, loss assessors, risk surveyors and managers. Premium income and profitability increased significantly between 2002 and 2006, although most insurers recorded underwriting losses for the 2006 financial year.[1231] The sector is regulated by the Commissioner of Insurance who is responsible to the Minister for Finance. However, the regulatory framework under the *Insurance Act, Cap 487 of 1987* requires reform to facilitate greater innovation and market development.[1232]

The Nairobi Stock Exchange is the centre of **capital market** activity in East Africa. Since it was established in 1954, it has grown currently listing 54 traded companies[1233] with a market capitalisation of Ksh.851.1billion in December 2007.[1234] Although before independence in 1963, trading was originally limited

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1228 Interest rates are benchmarked to the Central Bank Rate (CBR) set by the CBK on advice from the Monetary Policy Advisory Committee. Interest rates have been elevated by high oil prices, increased private sector borrowing, high imports of intermediate goods and increased public expenditure. The CBR was 8.75% in both November and December 2007; 12-month inflation declined from 14.6% (November 2006) to 12% (December 2007): Richard Harnley, 'Financial Markets: Regulation- Recent developments in banking and financial markets', [2007] J.I.B.L.R. N.38; CBK Monthly Economic Review, December 2007, pp.7,13; OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, p.305.

1229 CBK Monthly Economic Review, November 2007, p.28.

1230 Non-performing loans constituted 5.6% of total loan stock (Ksh103.3billion) in October 2007 but declined to 4.2% (Ksh59.1billion) in November 2007 due to write-offs and recoveries: CBK Monthly Economic Review, November 2007, p.29; UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.24.

1231 See Association of Kenyan Insurers: Insurance Industry Report for the Year 2006, p.3 available at <http://www.akinsure.com/images/AKI%20Insurance%20Industry%20Report.pdf>.

1232 UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.45.

1233 48 equities and 6 bond issues.

1234 CBK Monthly Economic Review, December 2007, p.47.

to Europeans, current regulations favour all resident investors.[1235] The Capital Markets Authority (hereafter: CMA) is responsible for regulation of the three operational segments of the stock exchange.[1236] The new Central Depository System provides scrip-less settlement on a T+5 cycle.

Financial sector policy under ERS has been influenced by the IMF/World Bank[1237] and focuses on faster privatisation and creating a favourable climate for increased private investment.[1238] Strategies to strengthen financial sector regulation include increasing the independence of CBK by transferring the Ministry of Finance's bank licensing, regulatory and supervisory roles to the Bank and by empowering the CMA to better regulate capital market institutions. Recent policy statements[1239] indicate that banks[1240] and insurance companies[1241] will be required to increase their capital in line with recapitalisation and consolidation developments elsewhere on the continent.[1242] These measures are proposed to enhance the capacity of indigenous financial institutions to compete with their foreign counterparts.

Tax incentives to facilitate financial development are considered in the next section.

[1235] 40% of listings of equities are reserved for Kenyan and EAC-resident investors and the balance may be freely subscribed by all investors: PricewaterhouseCoopers Kenya, 2007 Budget Bulletin: Miscellaneous, p.2.

[1236] *Viz.*, Main Investments Market, Alternative Investments Market, Fixed Income Securities Market and Futures and Options Market.

[1237] Under the Financial Sector Assessment Program.

[1238] Specific policies address controlling money-laundering and financing of terrorist activities by legislative reforms; enhancing the role of market forces in determining interest and deposit rates; and improving the ability of development/micro-finance institutions to provide targeted services to SMEs, agriculturalists and rural communities.

[1239] K Budget Speech 2007/2008, p.32.

[1240] From KShs250million to KShs1billion between 2007/2010.

[1241] Composite insurers (from KShs150million-KShs450million); general insurers (from KShs100million-KShs300million); long-term insurance (from KShs50million-KShs150million).

[1242] See above at **§3.2.3.1** of this Thesis.

5.2.3.2. Tax Incentives

Dividends, interest, pensions, charges, annuities and withdrawals from registered pension funds and home ownership savings plans are all taxable elements of income.[1243] Foreign exchange gains and losses are taxable and deductible (respectively) in computing the gains and profits of the relevant business.[1244] **Premium tax** is charged at 1½% of gross premiums underwritten and 5% of premiums paid to non-resident reinsurers.[1245] Resident financial service companies are liable to income tax at 30%. Financial and management advisory services, custodian services, executorships and trusteeship services attract VAT levies.[1246] Other financial transactions may also attract *ad valorem* stamp duty levies. Non-resident companies are taxed at 37.5% and suffer (final) withholding taxes on certain receipts.

As noted above, **withholding taxes** are levied on numerous receipts including dividends, interest, rents, royalties and fees.[1247] Withholding tax on **dividends** applies at 5% for residents and 10% for non-residents. Taxable dividends comprise distributions of profits as opposed to capital.[1248] Companies are obliged to establish special dividend tax accounts to ensure that dividends are payable only out of previously taxed profits.[1249] Withholding tax rates for **interest** payments vary from 15% to 25% depending on whether the relevant bearer instruments are issued by the government or by private issuers. Interest paid to non-residents in respect of certain government stocks are tax exempt.[1250] Taxable **rental income** for residents includes royalties, rents and premiums.[1251] For non-residents, withholding tax is levied on rents at 30% (for

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1243 §3(2) & 8, ITA 1973.
1244 §4A ITA 1973.
1245 §197(A-G) *Insurance Act 1987*.
1246 Third Schedule, Kenyan VAT Act.
1247 IBFD, African Taxation Systems: Kenya, *op cit*, p.14; *Income Tax (Withholding Tax) Rules 2001*.
1248 As such, gains from voluntary liquidations, bonus and discounted issues of debentures and preference shares constitute taxable income: §7 ITA 1973.
1249 §7A *ibid*. See also IBFD, African Taxation Systems: Kenya, *op cit*, p.7.
1250 §14 & First Schedule, ITA 1973.
1251 §6 ITA 1973.

immovable property) or 15% (if from movable property).[1252] **Fee income** earned by residents forms part of ordinary income and is subject to withholding tax at 5% on contractual fees and 10% on consultancy or agency fees. For non-residents, a final withholding tax of 20% is levied on certain fees.[1253]

Tax incentives for financial activities range from outright income and withholding tax exemptions to preferential deductions. Categories of **exempt income** include[1254] interest on certain government tax reserve certificates; fees, royalties and interest where the Kenyan government is a counterparty to the relevant agreement if certified to be in the public interest; and incomes accruing to registered pension and trust schemes, pension and provident funds, and annuity funds owned by insurance companies. **New and venture capital companies**[1255] are promoted by the generous tax incentives to encourage listings to deepen the capital markets. Newly listed companies are liable to income tax at **reduced rates** of 27% (or 25%) for 5 years (or 3 years) if at least 30% (or 20%) of the issued share capital is listed on any securities exchange approved under the *Capital Markets Act*.[1256]

Venture capital funds apparently enjoy a **10-year tax holiday**.[1257] **Dividends** received by venture capital companies are **tax exempt** as are capital gains from trading the shares of such companies subject to certain conditions. A **participation exemption/affiliation privilege** relieves tax on dividends if paid to a resident company owning at least 12.5% of the equity of the paying company.[1258] Dividends payable by certain financial institutions are tax

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[1252] In both cases, tax withheld is the final tax for the non-resident.

[1253] The relevant services include management, professional, sports and entertainment services: §8 ITA 1973; IBFD, African Taxation Systems: Kenya, *op cit*, pp.14-15.

[1254] See generally First Schedule ITA 1973.

[1255] *Viz.*, resident companies in which venture capital funds have invested which at the time of the first such investment had assets with market values or turnover of less than KSh500,000million: §2(1) ITA 1973; *Income Tax (Venture Capital Company) Rules, 1997*.

[1256] IBFD, African Taxation Systems: Kenya, *op cit*, p.7.

[1257] See 'About of NSE' webpage at <http://www.nse.co.ke/AboutNSE.htm>.

[1258] §7(2) ITA 1973.

exempt.[1259] Dividend and interest income from unit trusts and collective schemes investing employees' emoluments in listed securities are also tax exempt.[1260]

Tax exemptions extend to indirect taxes on transactions. Insurance and reinsurance businesses are **exempt from VAT**.[1261] **Stamp duty exemptions** are provided for share transfers between group companies. These exemptions also apply to the parent directly or indirectly holds at least 90% of the issued share capital of the relevant companies, and also for the transfer of undertakings to special purpose vehicles involved in securitisation and the offering of asset-backed marketable securities provided approved by the CMA.[1262]

Interest incurred in connection with loans utilised wholly and exclusively in the production of income is **tax deductible** subject to meeting certain thin capitalisation tests.[1263] **Deductibility** is provided for capex on legal costs and incidental expenses in connection with the issue and listing of shares, debentures and other securities. A **lessee** may also deduct lease rentals and capex incurred on legal costs and stamp duties in respect of a lease of ninety-nine years or less for property utilised for the business.[1264]

Recent incentives include: increasing tax exemptions for individual depositors operating home ownership savings plans;[1265] extending the deductibility of legal and other costs of issuing securities to existing listed companies wishing to raise additional capital on any registered stock exchange;[1266] and to extend the scope for deducting lease expenses for equipment, machinery and non-commercial vehicles.[1267] These measures are aimed at increasing access to

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[1259] §7(3) & Fourth Schedule, ITA 1973.
[1260] §20 ITA 1973.
[1261] Third Schedule, Kenyan VAT Act (Cap 476) 2004.
[1262] IBFD, African Taxation Systems: Kenya, *op cit*, p.23.
[1263] §16 ITA 1973 provides a minimum debt: equity ratio of 3:1 where equity includes both revenue reserves and issued/paid up capital of all categories.
[1264] §15 ITA 1973.
[1265] Up to a maximum of KSh3million: K Budget Speech 2006, ¶136/p.31.
[1266] To help deepen the capital markets: *ibid*, ¶145/p.33.
[1267] *Ibid*, ¶174/p.39.

finance or savings to indirectly encourage private sector investment. Other incentives proposed to directly promote development of infrastructure and basic services are considered in the next section.

5.2.4. INFRASTRUCTURE & BASIC SERVICES

5.2.4.1. Overview

Kenya's infrastructure for communications, transportation and basic services is relatively better developed than other countries in EAC CU, strategically placing her to serve as the regional economic hub. However, existing infrastructure requires urgent upgrading if Kenya is to fulfil her potential of serving the region in this way. Past governments have relied on donor aid and foreign development finance to provide and upgrade basic infrastructure and services. Promises to increase private sector participation have not been fulfilled. This section highlights the use of tax incentives to facilitate improvements in the provision of infrastructure and basic services.

5.2.4.2. Information, Communication & Technology (ICT)

The private sector has been responsible for much of ICT growth in recent years. Investment by Kencell and Safaricom[1268] has resulted in the phenomenal increase of the mobile subscriber base from 24,000 in 1999 to 1.6million in 2003[1269] and from 2.2.million in 2004 to 4.6million in 2005.[1270] The fixed-line sub-sector remains inefficiently run by Telkom Kenya despite the removal of Telkom's monopoly in 2004 or indeed, the decoupling in 1999 of Kenya Posts and Telecommunications Corporation into Telkom Kenya, the Postal Corporation of Kenya and the Communications Commission of Kenya.[1271] Unfortunately, the licensing of a second national carrier and a third mobile

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[1268] The subsidiary of the state-owned Telkom Kenya.

[1269] Van Buren 'Kenya: Economy,' *op cit*, p.579.

[1270] OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, p.300.

[1271] The decline in fixed-line teledensity from 1 to 0.9 in 100 persons between 2003 and 2004 underscores the need for the proposed second national carrier and the privatisation of Telkom Kenya. Telecommunications penetration remains low at 15% and 1% for mobile and fixed line services respectively: *ibid*.

telephony operator as proposed by the ERS [1272] was aborted in 2004. Implementation of ERS policies *vis-à-vis* the liberalisation of internet backbone and voice-over-internet sub-sectors has led to cheaper services, more licensed internet service providers, and increased competition from private operators.[1273]

5.2.4.3. Transportation

Kenya's **road network** consists of 151,000km of classified and unclassified roads which are under the responsibility of the Ministry of Public Works and other public agencies. The poor state of roads is often cited as a disincentive to investment by local and foreign investors.[1274] Due to inadequate public funding and dispersed official responsibility, road infrastructure has depreciated since the 1990s. Under the Roads 2000 project, labour-based construction and rehabilitation of roads is financed primarily through external financing from donors and development partners with the government contributing funds from the Fuel Levy Fund and a Constituency Development Fund.[1275] ERS policies also focus on rehabilitating and maintaining feeder roads in ASALs.[1276]

Despite their historical significance, Kenya's 2765km **railway network** has been poorly managed by the state-owned Kenya Railways, resulting in underutilisation of its 7million tonnes annual capacity. The need to provide efficient rail services is underscored by the potential to expand regional transit traffic beyond existing routes serving Kenya's landlocked neighbours. However in October 2005, Kenya Railways Corporation and its Ugandan counterpart jointly concessioned the South African Rift Valley consortium led by the Sheltam Rail Company to manage the Kenyan and Ugandan railway network for 25years. The IFC advised on the concessioning which should see freight and

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1272 IMF/Kenya: ERS 2003/2007, pp.42-47.
1273 UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.18.
1274 *Ibid*, p.20.
1275 OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, p.305.
1276 IMF/Kenya: ERS 2003/2007, p.59.

passenger services improve by better management and increased investment in infrastructure.[1277]

The port of Mombasa has traditionally served as the regional hub for **marine transportation**. Containerised trade has increased remarkably in recent years despite growing competition from Tanzania's port of Dar es Salaam. Mombasa's ports and the inland container depots at Nairobi, Kisumu and Eldoret are managed by the state-owned Kenya Ports Authority. However, proposals under ERS seek to redefine the Authority's role making it a landlord port authority, while ceding cargo clearing and other services to private sector operators.[1278] International **air traffic** is routed through international airports at Nairobi, Mombasa and Eldoret. Volumes of international and domestic air traffic rates have increased in recent years particularly since the successful privatisation of Kenya Airways in 1996.

5.2.4.4. **Basic Services**

Under ERS, the Kenyan government hopes to improve delivery of drinking/portable water, sanitation, housing, healthcare and other basic services to its citizens. Kenyans are to benefit from increased private sector participation and greater community involvement in **water supply** schemes and **sanitation services** as envisaged by the *Water Act 2002.*[1279] The Act decouples the policy formulation, service delivery and regulatory functions of the state to improve the performance of parastatals. Reforms to improve water supplies and sanitation services in both rural and urban areas are being coordinated under the National Water Resources Management Strategy and the National Water Services Strategy and Investment Plan (both initiated in 2003).[1280]

1277 OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, pp.305-306; UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.21.

1278 OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, p.306; see also UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.21.

1279 *Ibid*, p.19.

1280 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, pp.310-312.

Kenya's relatively high rates of school attendance and literacy[1281] are set to increase under the NARC government's proposals with ERS. Increased spending on free primary **education** and teachers' salaries has corresponded with higher enrolment of 1.5million children in 2003. ERS also focuses on especially vulnerable groups such as the girl child and children from the disadvantaged ASALs.[1282]

While Kenya's **healthcare** delivery system fares well compared with her regional neighbours,[1283] there are significant health challenges particularly due to HIV/AIDS, tuberculosis, drug-resistant malaria and other diseases. Some progress has been made particularly as regards reducing the HIV/AIDS prevalence rates from 14% to 7% between 2002 and 2006.[1284] ERS policies respond to these challenges in a variety of ways including increased funding of healthcare for poor and disadvantaged groups,[1285] the provision of better treatment and drugs, and greater coordination of public efforts with the initiatives of donors and development partners.[1286]

Closely tied to the delivery of infrastructure and basic services for the urban poor is the provision of affordable **housing**. Slum and shanty-town occupants are to benefit from proposals under ERS to develop 150,000 housing units per annum, facilitate finance by way of secondary market mortgages and encourage increased private sector investment.[1287] Kenyan tax law and Budget proposals respond to some of these challenges by the provision of fiscal measures.

[1281] 88% of men and 79% of women were literate being the highest rates in the East African region: UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.22.

[1282] Other noteworthy initiatives include developing core skills in pupils and decentralising authority from the central government to local administrators: IMF/Kenya: ERS 2003/2007, p.51.

[1283] See Table II.4 *Health*: UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.19.

[1284] Further success is to be achieved under the HIV/AIDS Strategic Control Plan 2005-2010 implemented by the National Aids Control Council: see further OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, p.307.

[1285] By increasing the budget allocation for health from 5.6% to 12% by 2007.

[1286] IMF/Kenya: ERS 2003/2007, pp.51-53; OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, pp.313-314.

[1287] *Ibid*, p.59.

5.2.4.5. **Tax Incentives**

General rules apply in the taxation of entities engaged in infrastructure and services.[1288] Kenyan tax statutes feature an eclectic collection of tax measures aimed at promoting activity in the infrastructure, ICT and basic services sectors. Several direct (income) tax incentives address these aims. For instance, subject to reciprocity, incomes accruing to non-resident owners of air transportation businesses are **exempt from income tax.**[1289] Capital allowances are available by way of **wear and tear deductions** to relieve income tax liability. The relevant annual rates are 30% for computers, peripheral computer hardware, calculators, copiers and duplicating machines; 25% for self-propelling vehicles including aircraft; and 12.5% for ships and other machinery.[1290]

Firms may also benefit from wear and tear deductions by deducting 2.5% per annum of eligible capex over 40 years. Eligible capex covers expenditures incurred in connection with industrial buildings. 'Industrial buildings' comprise: docks, bridges, tunnels and inland navigation facilities; and undertakings for the supply of water for public consumption and of hydraulic power.[1291] Special provisions grant **accelerated deductions** to owners and operators of shipping businesses. Such owners or operators may deduct 40% of the cost of the purchase and refitting of a new or used ship of more than 495 tonnes gross in the first year of use.[1292] However, a special tax is imposed on purchasers of second-hand motor cars assessed at varying rates.[1293]

1288 Although there are some unique provisions; e.g. a telecommunications tax is imposed on users of telecoms services and apparatus at 15% of the user fees: IBFD, African Taxation Systems: Kenya, *op cit*, p.21.
1289 First Schedule, ITA 1973.
1290 ¶7 Second Schedule, ITA 1973.
1291 ¶5 Second Schedule, *ibid.*
1292 This is subject to the limitation of one of such deductions per ship; claw-back provisions are applicable if the vessel is disposed of within 5 years of the deduction: ¶25 Second Schedule ITA 1973.
1293 IBFD, African Taxation Systems: Kenya, *op cit*, p.21.

Other tax incentives are implemented through indirect tax measures. Designated VAT-able services include certain computer services,[1294] engineering and telecommunication services, and services of clearing and forwarding agents.[1295] Certain provisions **exempt** the transportation of passengers by means other than hire from VAT[1296] while others provide for **VAT remissions** for taxable services provided to public road rehabilitation projects financed by private sector donations.[1297] Imported ships and boats are also **exempt from customs duties.**[1298]

Some incentive measures were proposed under the 2006 Budget. Some measures target the provision of **basic services**. For instance, the supply of portable water by public bodies was to be zero-rated for VAT.[1299] Unspecified tax incentives were promised to promote **private sector investment** in road infrastructure and the management of Mombasa Freeport.[1300] Private sector finance of infrastructural development was to be further encouraged by tax deductions for the construction of public **schools, hospitals and roads** through private-public partnerships.[1301] Land transactions in respect of new schools were to enjoy **stamp duties exemptions** and **industrial building allowances** were to be extended to the construction of hostels and other educational buildings.[1302] Financial incentives were offered by way of **income tax exemptions for interest from bonds and asset-backed securities** issued to finance infrastructural development and social services.[1303] Other unspecified measures were proposed to strengthen Kenya's ICT position in East Africa and provide employment for the youth.[1304] These proposals would appear to deliver on government's commitment under ERS to introduce targeted incentives for

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1294 These include bureau services facilities, systems analysis and design, software development and training. Educational services are however excluded.
1295 Fourth Schedule, Kenyan VAT Act.
1296 Second Schedule, *ibid.*
1297 §23, *ibid.*
1298 IBFD, African Taxation Systems: Kenya, *op cit*, p.20; *Customs & Excise Act 1978.*
1299 K Budget Speech 2006, ¶123/p.29.
1300 ¶¶80 & 84/pp.19-20, *ibid.*
1301 ¶140/p.32, *ibid.* See also Second Schedule, ITA 1973.
1302 K Budget Speech 2006, ¶¶137-138/p.32.
1303 ¶143-146/p.33, *ibid.*

supplies of computer software/hardware to improve accessibility for micro-entrepreneurs and low income earners.[1305]

Only a few additional incentives were provided for by the 2007/2008 Budget. Leased aircraft equipment and certain maritime equipment/vessels were to be **zero-rated for VAT**.[1306] Developers constructing low income housing for rental purposes would be eligible for **industrial building allowances**. Inputs utilised in construction low income housing in excess of 20-units in planned development schemes were to be zero-rated for VAT.[1307] The trend of placing private sector initiatives at the fore-front and increasing linkages between education, entrepreneurship, trade and industry are reflected in the incentives examined next.

5.2.5. MANUFACTURING, TRADE & INDUSTRY

5.2.5.1. Overview

Kenya's manufacturing and industrial base is driven by an established private sector involving significant foreign investment from predominantly Western multinationals. Industrial FDI is complemented by substantial public sector indirect participation. Numerous opportunities exist in textiles,[1308] metal, steel and vehicle-parts assembly, [1309] electronics and engineering, cement and construction, ceramics and glass, plastics and chemicals, [1310] and

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1304 ¶86/p.20, *ibid.*

1305 IMF/Kenya: ERS 2003/2007, p.43.

1306 PricewaterhouseCoopers Kenya, 2007 Budget Bulletin: VAT, p.2.

1307 K Budget Speech 2007/2008, p.31.

1308 In the early 1990s, the textiles/apparel industry attracted Asian inward investment exploiting Kenya's quota under the US *African Growth and Opportunity Act 2000* (AGOA). Under AGOA (and *AGOA Acceleration Act 2004*) certain products (including apparel) from eligible African countries may be exported duty-free to the USA. However, recent changes in the AGOA policies mean greater competition from countries like China and a lack of investment in capacity building at lower levels in the local fabric supply chains: UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, Box III.6, p.47; van Buren 'Kenya: Economy,' *op cit*, p.577.

1309 UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, Box III.4, pp.42-43; van Buren 'Kenya: Economy,' *op cit*, p.577.

1310 Refining and processing of imported petroleum by Kenya Petroleum Refinery Limited (a joint-venture substantially owned by Shell) to meet domestic demand and for re-export has spawned a large petrochemicals industry: *ibid*, p.578.

pharmaceuticals.[1311] Much industrial activity involves manufacturing or local assembly (utilising imported components, technology and machinery) for domestic or regional consumption (as opposed to world markets). This trend stems from the import-substitution policies of the 1960s/1970s and the late shift towards promoting export-oriented manufacturing and industrial activity in the late 1990s.

While average growth in industrial output was 10.5% between 1965 and 1980, productivity stalled significantly in the 1990s with growth in manufacturing GDP averaging at a record low of 1.9% between 1990 and 2002.[1312] Happily, manufacturing and industrial activity is gradually recovering: recent growth has been driven by rising domestic and regional demand causing output to increase from 2.7% (2003/04) to 4.1% (2004/05).[1313] In 2005, manufacturing contributed 14% of GDP growing by 5% due to certain tax incentives for intermediate goods and enforced anti-dumping measures.[1314] Tax incentives and EPZ initiatives were also instrumental in increasing manufacturing output in 2007.[1315]

ERS policies to promote industrial productivity are couched in very general terms. Besides the removal of barriers to business, reduction of costs and improvement of the environment for labour-intensive industrial growth, other policies are to be determined in consultation with the private sector in a proposed Industrial Master Plan.[1316] However, existing provisions in Kenyan tax law provide numerous and generous fiscal incentives to promote (export-oriented) manufacturing and industrial activity.

1311 *Ibid*, pp.41-43.
1312 Van Buren 'Kenya: Economy,' *op cit*, p.577.
1313 OECD/AfDB, *African Economic Outlook 2004/05 – Country Studies: Kenya*, p.298.
1314 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, p.302.
1315 CBK Monthly Economic Review, November 2007, p.18.
1316 IMF/Kenya: ERS 2003/2007, p.50.

5.2.5.2. Tax Incentives

Manufacturing and trading companies are taxable on normal rules depending on whether they are resident or non-resident entities. As noted above, losses may be carried forward indefinitely but not carried back.[1317] Industrial and trading companies benefit from normal deductions for R&D expenditure, advertising expenditure and employees' meals provided at office residences.[1318]

Certain depreciation allowances are specifically targeted at industrial firms. **Annual capital allowances** are granted for computers (at 30%), self-propelling vehicles (at 25%) and all other machinery (at 12.5%).[1319] Modest **wear and tear deductions** permit 2.5% annual allowances for industrial buildings expensing related capex over 40 years. Eligible facilities include accommodation for employees, mills, factories, manufacturing facilities, storage and transport facilities.[1320] More generous accelerated depreciation is provided by way of special **investment deductions**. These permit up to 100%[1321] of capex incurred on buildings and machinery to be deducted by way of investment allowances in the first year the relevant asset is utilised. However, outlays on facilities for design, storage, transportation and administration facilities are excluded.[1322] Certain provisions extend these special investment deductions to manufacturing-under-bond and export processing zones.[1323]

Export-oriented activities enjoy the most generous incentives available under Kenyan tax law, perhaps reflecting the importance of generating foreign exchange to improve the balance-of-trade and external debt positions. Export-oriented manufacturing activities at **licensed customs bonded factories** are promoted by numerous incentives. Imported capital equipment and machinery

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1317 IBFD, African Taxation Systems: Kenya, *op cit*, p.6.
1318 §15 ITA 1973.
1319 ¶7 Second Schedule, ITA 1973.
1320 ¶5 Second Schedule, ITA 1973.
1321 Varying percentages are applied depending on the year in which the expenditure is incurred and the location of the investment. In the main, expenditures after 2004 enjoy 100% deductions as do investments outside Nairobi and Mombasa.
1322 ¶24 Second Schedule, ITA 1973.

utilised at such facilities are entitled to **VAT remissions** as are other capital goods acquired for sums in excess of KSh5million for industrial and other activities to generate foreign exchange earnings.[1324]

The *Export Processing Zones Act (Cap 517) 1990* (hereafter: EPZ Act 1990) provides a raft of liberal fiscal incentives targeted at promoting and facilitating export-oriented manufacturing and services. The enabling environment is provided by the designation by the Minister for Trade and Industry of certain geographical locations as export processing zones to be supervised by an Export Processing Zones Authority.[1325] To be eligible for licensing, prospective enterprises must: be incorporated in Kenya with the sole objects of producing goods and services for export within a zone; intend to be engaged in eligible export-oriented activities which do not constitute a health hazard or have adverse effects on the environment; and engage in lawful activities in compliance with applicable laws.[1326]

Licensed export processing enterprises must be engaged in specified manufacturing,[1327] service[1328] or commercial[1329] activities.[1330] Certain regulations circumscribe the freedom of EPZ enterprises to operate in the zones: manufactured goods and services must be for export only to other jurisdictions or export into Kenya's customs territory (whereupon they are deemed to be imported into Kenya and subject to normal import and customs procedures). Goods may be repaired, maintained and converted in Kenya under the supervision of the EPZ Authority.[1331] No retail trade is allowed within the

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1323 ¶¶24A & 24B, *ibid.*
1324 §23 Kenyan VAT Act.
1325 §§3 & 15, EPZ Act 1990.
1326 §23 *ibid.*
1327 Manufacturing here excludes installation and agricultural activities and relates to conversion and assembly activities.
1328 Eligible conversion activities include trading in, breaking bulk, grading, repacking or re-labelling goods and industrial raw materials.
1329 *Viz.*, export-related consultancy, information, brokerage and repair services are eligible; however, services usually provided through off-shore financial centres are excluded.
1330 §2 EPZ Act 1990.
1331 §§24 & 25, *ibid.*

zones though it appears this rule has been recently relaxed to allow 5% of goods to be traded in the local market.[1332]

The wide-ranging incentives granted to EPZ enterprises include **exemption** from existing and future **VAT, customs and excise regulations and duties** on all imports used for export production. The most generous measures are the income tax incentives: an extravagant **ten-year tax holiday** is granted providing income tax exemption for the first decade of productive operations. On expiry of the ten-year income tax holiday, a **reduced income tax rate of 25%** applies for **yet another ten years. Withholding tax exemptions** are tied to this 20-year period in that payments to non-resident individuals and entities in respect of dividends, interest, royalties and other disbursements are tax exempt. Further **exemptions** apply for **stamp duties**, import and export provisions, foreign exchange regulations, rent and tenancy controls, and local provisions regarding **individual income tax** for non-resident employees.[1333] Finally, the first year 100% special **investment deductions** applicable under the ITA 1973 are extended to expenditure by EPZ enterprises on buildings and machinery.[1334]

In the last decade, EPZ activity has increased significantly. However, the majority of EPZ operations are foreign owned[1335] and engaged in the garments sector.[1336] Although most EPZs are located in Mombasa,[1337] the Athi River EPZ

[1332] §26, *ibid*; IBFD, African Taxation Systems: Kenya, *op cit*, p.vii.

[1333] §29 EPZ Act 1990; IBFD, African Taxation Systems: Kenya, *op cit*, p.viii.

[1334] ¶24B Second Schedule, ITA 1973.

[1335] Local Kenyans owned only 13.2% of firms and participated in another 29.4% by joint ventures in 2005. Foreign investors from Asia, Europe, the Middle East and Africa owned 57.4% of EPZ enterprises: see EPZ Authority Annual Report for the Year 2005, (hereafter: 2005 KEPZA Report) Kenyan Export Processing Zones Authority, pp. 16, available at <http://www.epzakenya.com/news.php?type=publication>.

[1336] In 2005, garments contributed the greatest percentage of employment (90%), number of firms (36.8%), total sales (63.9%), exports (74.4%) and local resource utilisation (52.1%). Other active sectors included agro-processing, chemicals, services, printing, pharmaceuticals and electronics: 2005 KEPZA Report, p.15.

[1337] Mombasa hosted 21 of the 43 gazetted EPZs in 2005; other EPZs were located in Nairobi, Athi River, Kilifi, Voi, Malindi and the Keria Valley: *ibid*, p.10.

is the most active of the 43-odd zones.[1338] Unfortunately, recent EPZ performance has been disappointing: only 65% of the EPZs were operational in 2005[1339] with another 18.66% of the zones being listed for de-gazettement for numerous reasons including change in external policies, low demand for EPZ tenants, loss of investors' interest in the scheme and financial difficulties.[1340] Operational EPZ firms reduced from 74 to 68 in 2005 matching declines in totals sales and exports.[1341]

Several factors contributed to this recession. First, key external policy changes affected demand. In particular, the expiry of textile quotas under the World Trade Organisation (hereafter: WTO) rules in early 2005 meant Kenyan garment exporters were exposed to fierce competition from more efficient producers in Asian countries notably India, Pakistan, Bangladesh and China. Secondly, on the supply side, relatively high Kenyan labour, electricity and other production costs which were acerbated by adverse government policies[1342] undermined export competitiveness. Low labour productivity contributes to the inability of the domestic cotton industry to improve the quality of supplies to take full advantage of the extension of the third country fabric requirements under the AGOA.[1343]

On a positive note, employment increased marginally by 0.9% as 38,051 Kenyans were directly employed in EPZ firms.[1344] As a result of declining exports of garments to the US market, firms diversified and pioneered inroads

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1338 Attracting the greatest percentage of firms (29.4%), local employment (23.3%), and investment (29.5%) in 2005: *ibid,* pp.14-15.

1339 2.3% were complete but unoccupied: *ibid,* p.10.

1340 See Table 4, 2005 KEPZA Report, p.12.

1341 Sales and exports declined by 1.8% and 13.1% in 2005 to Ksh.23.774billion and Ksh.20.038billion respectively: *ibid,* p.9.

1342 *Vis-à-vis* petroleum imports duties, labour laws, customs clearance regulations and immigration.

1343 The AGOA which was to expire in 2008 was extended till 2015 by the African Investment Incentive Act of 2006 (20.12.06). In addition, the third country fabric requirements (under which AGOA accredited countries could source from third countries fabrics used to manufacture garments for export to the US market) has been similarly extended from September 2007 till September 2012.

1344 Total employment stood at 50,735 in 2005: 2005 KEPZA Report, p.9.

into the Canadian, European and Middle Eastern markets.[1345] Despite the extension of the AGOA till 2015, the dominance of the US market as the main export destination underscores the vulnerability of the Kenyan EPZ scheme to changes in external policy.[1346]

On the whole, these generous EPZ incentives seem to have achieved some positive results, with total investment growing 109% from Ksh.8.95billion in 2001 to Ksh.18.682billion in 2005.[1347] Certain studies show that import duty waivers on capital goods and other imports have improved recent manufacturing performance.[1348] Evidently hoping to consolidate these successes, budgetary proposals promise additional incentives for manufacturing. In conjunction with Finance Ministers of the other EAC CU countries, import duty is to be removed for equipment utilised in the harnessing of solar power, oil and fuel filters, and inputs for metal fabrication. Import duty is also to be reduced for unprinted aluminium foil and increased for imported floor coverings, mats and matches.[1349] Sugar development levies and tariffs on certain imports are also reduced.[1350] These measures are to protect local infant industries and enhance their competitiveness.

As noted above, industry is slowly recovering from years of decline. Some commentators have criticised poor government policies for the poor performance of the past. Specific policies attracting such censure include a focus on first-stage import substitution[1351] in lieu of export-oriented manufacturing; undue accommodation by successive governments of multinationals and importers' interests to the detriment of indigenous industrialists; preference for production of (non-essential) luxury goods instead of (necessary) agricultural inputs which could improve food security;

[1345] *Ibid*, p.19.
[1346] *Ibid*, p.24.
[1347] Table 1, 2005 KEPZA Report, p.9.
[1348] OECD/AfDB, *African Economic Outlook 2004/05 – Country Studies: Kenya*, p.268.
[1349] K Budget Speech 2006, ¶¶152-154/p.35.
[1350] K Budget Speech 2007/2008, pp.26,28.
[1351] The assembly of final products as opposed to intermediate components or value-additive manufacturing.

and corruption, mismanagement and policy inconsistencies as regards import controls and tariffs.[1352]

Other suggested causes for the decline are expensive and irregular power supply, poor infrastructure and excessive red-tape in customs clearing procedures.[1353] Much of these shortcomings disproportionately affect microenterprises. The next section considers some of the incentives granted specifically to improve investment conditions for smaller businesses.

5.2.6. MICRO-ENTERPRISES

5.2.6.1. Overview

Kenyan micro-entrepreneurs face significant environmental challenges in competing with each other and their larger, foreign-owned counterparts. Prior to independence, Asian entrepreneurs emerged as successful merchants and industrialists supported by strong, mutually-supportive ethnic and lingual ties. Indigenous African entrepreneurship evolved much later capitalising on commercial opportunities facilitated by political reforms, demand for commodities associated with the Second World War and the indigenous demand for new goods and services.[1354]

The small and medium sized enterprises (SME) sector has since grown, contributing significantly to job-creation.[1355] Kenyan SMEs usually trade as sole traders or partnerships with a more a limited scale of operations than their foreign-owned counterparts. However, increased linkages between indigenous enterprises and foreign-owned industries have led to new opportunities in export-oriented agriculture and horticulture, tourism, small-scale and export-oriented manufacturing, local industrial assembly, retail trade and tourism. An

1352 Miller and Yeager, *Kenya: the Quest for Prosperity*, *op cit*, pp.140-146.
1353 OECD/AfDB, *African Economic Outlook 2005/06 – Country Studies: Kenya*, pp.298-299.
1354 Miller and Yeager, *Kenya: the Quest for Prosperity*, *op cit*, pp.27-29.
1355 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, p.314.

emerging, industrious and capitalistic middle class augments local demand for indigenously-produced goods and services.[1356]

Problems with poor transportation, electrical and other infrastructure fall disproportionately on micro-enterprises. Access to finance is problematic with only 10% of the population enjoying access to banking services.[1357] Indigenous investors are more likely to complain of lack of government support, bureaucracy and corruption.[1358] ERS proposes to rectify the perceived lack of support by improving access to finance for SMEs.[1359] Fiscal measures which may promote micro-enterprises within various economic sectors are considered in the next section.

5.2.6.2. Tax Incentives

Some provisions in Kenya's investment law appear to discriminate *against* SMEs. For instance, requirements for the investment certificate issued under the *Investment Promotion Act 2004* make it mandatory for local investors to invest a minimum of KSh.5million (US$65,000) to be eligible.[1360] Given the extensive nature of Kenya's business regulation and licensing requirements, this provision would seem unduly onerous if not perverse.[1361] SMEs, however, may benefit from the numerous fiscal incentives applicable to the different sectors considered in this Chapter. **Agricultural** SMEs could take advantage of special deductions for farm works and agricultural equipment to reduce the financial burden of capital investment. Numerous opportunities exist to exploit VAT exemptions and zero-rating for agricultural supplies and inputs.

[1356] Van Buren 'Kenya: Economy,' *op cit*, p.573.
[1357] OECD/AfDB, *African Economic Outlook 2004/05 – Country Studies: Kenya*, p.274.
[1358] UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.61.
[1359] IMF/Kenya: ERS 2003/2007, p.37.
[1360] UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.51.
[1361] Small companies less able to engage expensive business consultants and tax advisers to navigate through the regulatory maze would be deterred by the high financial threshold and yet, their better-heeled counterparties which are better equipped to deal with the extensive licensing regime would freely receive all necessary licenses and permits.

Many SME suffer from inability to raise **finance** to fund expansion or acquire new technology. As noted above, **new and venture capital companies** are entitled to generous tax incentives by way of reduced income tax rates of 25% (or 27%) for 5 (or 3 years) to encourage them to list their securities. By definition, these venture capital companies are SMEs[1362] with bright enough prospects to attract funding from venture capital funds.[1363] By exploiting the benefits for venture capital companies, some of these financing constraints may be mitigated. Leasing options also provide some advantages for SMEs unable to buy capital assets outright.

Finance-related incentives would be of great benefit to SMEs active in the **manufacturing and trade** sectors given the capital and technological intensive nature of these undertakings. However, by qualifying as EPZ enterprises, SMEs could exploit the extensive incentives available, particularly the generous tax holidays, reduced income tax rates and VAT/duty exemptions. Indeed, this has been the strategy of many SMEs engaged in the garment sector, given the large numbers located in Kenya's EPZs. However export-oriented trade comes with international risks, as the recent expiry of the Multi-fibre Arrangement in the textile sub-sector illustrates. Despite generous fiscal incentives and numerous AGOA opportunities, the sector has been unable to capitalise on recent successes to develop the high-quality price-competitive edge to compete with larger competitors such as China.[1364]

SMEs engaged in **infrastructural development and basic services** would generally benefit more from the structural reforms of these sectors to permit greater private sector participation. However, existing VAT, stamp duty and customs duty preferences would be useful. To expatiate, VAT provisions set a minimum financial threshold for taxable persons. Businesses making supplies

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1362 As their original market values or turnover would be less than Ksh.500,000million: §2(1) ITA 1973.

1363 *Income Tax (Venture Capital Company) Rules, 1997*; IBFD, African Taxation Systems: Kenya, *op cit*, p.7.

1364 OECD/AfDB, *African Economic Outlook 2004/05 – Country Studies: Kenya*, p.26; UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, p.47.

of taxable goods and services which do not exceed KSh.3million over a 12 month period[1365] need not register for VAT.[1366] Budgetary proposals increase the threshold for compulsory VAT registration to KSh5million to reduce compliance costs for smaller taxpayers. A **turnover tax** was introduced to capture taxpayers with turnovers of less than KSh5million. These firms would be liable to tax at 3% on turnover, subject to a maximum KSh150,000 charge. However, due to defective drafting, the commencement date was postponed to 1 January 2008.[1367]

The next section considers incentive opportunities for SMEs and other firms active in the tourism and entertainment sectors.

5.2.7. TOURISM & ENTERTAINMENT

5.2.7.1. Overview

The growth of the tourism/services sector over the last decade has been phenomenal, contributing 50% of GDP in 2005.[1368] Local attractions range from the famous beaches, national and marine parks, game and biosphere reserves to archaeological sites attracting predominantly European and American tourists. Concerns over terrorism and insecurity instigated negative travel advisories by the British and American governments in 2003. These actions resulted in a massive loss of custom as tourist bookings were cancelled and arrivals shrunk. The introduction of tourist police, anti-terrorism squads and other security measures has allayed much of the security concerns. Arrivals from traditional tourist-generating countries (Germany, the UK, Italy, the US and France) have increased and tourism receipts are recovering due to

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1365 Or KSh.2.4million in 9months, KSh.1.8million in 6months or KSh.1.2million in 3months: Sixth Schedule, Kenyan VAT Act.

1366 However, these SMEs may voluntarily elect to register if they so desire: ¶3, Sixth Schedule, *ibid.*

1367 K Budget Speech 2006, ¶175/p.39 cf. PricewaterhouseCoopers Kenya, 2007 Budget Bulletin: Direct Tax, p.3

1368 OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, pp.300,302.

enhanced marketing, diversification and security.[1369] However, international arrivals and departures have declined in late 2007/early 2008 due to the increasingly unstable political situation. The political aftermath of the disputed December 2007 elections is likely to acerbate this decline.[1370]

New ERS initiatives seek to attract visitors from the Asia-Pacific region, encourage domestic tourism, develop new tourist circuits, increase private and community participation in the sector, and ensure preservation of wildlife and environmental resources.[1371] Entertainment services are also promoted with cultural performance, plays and other leisure activities. These initiatives seek to promote Kenya as a desirable Meetings, Incentives, Conference and Exhibitions venue.[1372]

5.2.7.2. **Tax Incentives**

Tourism as a major earner of vital foreign exchange has been encouraged by non-tax measures[1373] as well as fiscal incentives. Tax incentives include special first year **100% investment deductions** which are allowed for expenditure on the construction of hotel buildings duly certified by the Commissioner of Tax as industrial buildings. These deductions extend to outlays on staff quarters, kitchens, entertainment and sporting facilities integral to the hotel complex.[1374]

Numerous **VAT exemptions** exist for tour operators and travel agents, entertainment services, accommodation and restaurant services, conference services and the transportation of tourists.[1375] In addition, supplies for materials and equipment for use in the construction or refurbishment of tourist hotels, and services supplied by hotels to foreign travel and tourism promoters

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1369 Tourist arrivals increased by 14.5% in 2006 to 954,355 tourists mainly from Europe (56.3%): CBK Monthly Economic Review, February 2007, p.19.
1370 CBK Monthly Economic Review, December 2007, p.20.
1371 IMF/Kenya: ERS 2003/2007, pp.48-49.
1372 UNCTAD-ICC, *An Investment Guide to Kenya, op cit*, pp.39-40.
1373 E.g. the exemption of hotels in Mombasa and other coastal areas from electricity rationing scheme in 2000: van Buren 'Kenya: Economy,' *op cit*, p.580.
1374 ¶¶5 & 24, Second Schedule ITA 1973.
1375 Third Schedule, Kenyan VAT Act.

are zero-rated[1376] in line with ERS proposals for tax incentives for tourism infrastructure refurbishment.[1377] Finally, restaurant, bar and beverage services provided by restaurant owners or operators, and accommodation and other amenities provided by hotel owners or operators were previously subject to a reduced VAT rate of 14%.[1378] This reduced rate was replaced in 2006 with the uniform 16% rate for all VAT supplies.[1379] However, services provided by Kenyan artistes are to be exempt from VAT.[1380]

[1376] Fifth Schedule, *ibid*.
[1377] IMF/Kenya: ERS 2003/2007, p.49.
[1378] First Schedule, *ibid*.
[1379] K Budget Speech 2006, ¶168/pp.37-38.
[1380] *Ibid*, ¶128/p.30.

5.3. CONCLUSION

This Chapter summarises key aspects of the historical and political development of the Kenyan legal and tax system. It notes salient features of the Kenyan investment and regulatory environment and highlights key aspects of the Kenyan tax system. It also reviews existing Kenyan tax incentives against the background of the economic sectors in which these measures operate. Finally, it concludes the part of this Study concerned with the exposition and review of tax incentives in Nigeria, South Africa and Kenya.

Diverse fiscal measures are utilised to build upon ERS/Vision 2030's policy initiatives and promote economic growth and development in Kenya. Numerous incentives promote **agricultural** productivity. In the main, these incentives tend to promote large-scale, mechanised and capital-intensive agricultural production. Other more general transaction-based tax incentives have a wider reach to benefit less-capital intensive modes of farming by smallholders and communities. There are considerably more incentives for the **mining and power** sectors than the **energy** sector, but this is understandable given the better prospects of the former. Various **finance-based incentives** are provided to promote new ventures and firms, deepen capital markets and promote private sector capital formation. The private sector's role in contributing to the provision of vital **infrastructure and basic services** has been recognised by several incentives targeted at promoting private investment. However, major structural reforms are long overdue.

There is a noticeable emphasis on the promotion of export-oriented industrial activity particularly for regional trade within the EAC CU and global trade with the EU, Asia and the USA. This trend is mirrored by fiscal measures to promote economic sectors vital to generate foreign exchange earnings and improve Kenya's balance of trade position. **Tourism, export-oriented agriculture, manufacturing for export** and local assembly for regional markets are all actively encouraged. Less emphasis is placed on fiscal measures to address **SME development, basic infrastructure/services**, poverty alleviation and domestic food security. These issues appear to be relegated except where addressed by joint initiatives with donor countries, development finance agencies and international lending consortiums. However, some fiscal support is provided for these sectors. Key issues emerging from this Chapter include the modest success Kenya has experienced in implementing its EPZ regime; the promotion of export-oriented agricultural and industrial production; and the relatively advanced economic integration in the EAC.

Chapter 6 examines international tax law issues such as the dynamic interaction of source and resident country tax policies and the implications these pose for tax incentive design, tax treaty negotiation, and the wash-out or pass through of tax incentives. It considers the impact of regional integration arrangements on national tax incentive policies within the context of combating harmful tax competition and promoting regional fiscal cooperation. However, international tax obligations are not the only international influences constraining tax incentive policy. Chapter 6 also considers two other constraints – international trade regulations and international finance arrangements – and their effect on tax incentive policies. The discussions in Chapter 6 lead on to more critical analysis in Chapter 7 of Nigerian tax incentives law and policy with lessons from the South African and Kenyan experiences.

6. REGIONAL & INTERNATIONAL TAX, TRADE & FINANCE POLICY ISSUES

"Experience has shown that the more quickly the economy grows, the more quickly a fairer distribution of income takes place ... the basic recipe for success remains much the same: we need to maintain fiscal discipline and continue our struggle against inflation; we must encourage domestic and foreign investment; we must continue with privatization; we must open our economy in a responsible manner to domestic and global competition; and if we wish to create jobs, we must above all develop a more flexible and productive labour system. We should furthermore insist on cost-effective, efficient and honest government."[1381]

6.0. INTRODUCTION

The preceding three Chapters have reviewed the tax incentive policies of Nigeria, South Africa and Kenya in varying degrees of detail. These Chapters demonstrate how tax incentive policies have been codified into fiscal legislation in these countries. However, there are certain international influences that affect these policies. The constraints they impose on the tax incentive policies of Nigeria, South Africa and Kenya form the subject matter of the present Chapter. By considering the works of various authors, commentators and institutions, this Chapter analyses and reviews certain aspects of the international tax, trade and finance matrix that developing countries such as those considered in this Thesis must necessarily navigate in the pursuit of economic development through fiscal incentives.

1381 Nobel Peace Prize Laureate F.W. de Klerk, *The Last Trek: A New Beginning: The Autobiography*, (Macmillan, London: 1998), p.396.

6.1. INTERNATIONAL TAX LAW & POLICY ISSUES

6.1.1. Introduction

This Chapter starts with a consideration of aspects of international tax law which affect tax incentive policies in developing countries. The interaction of international tax law with national fiscal policies raises numerous issues not least of which concern mechanisms for targeting FDI incentives, designing withholding tax policies, ensuring unilateral or treaty relief from international double taxation and expanding the scope of tax treaty networks.[1382]

A general review of the principles and practices of international tax law is beyond the scope of this Thesis.[1383] Indeed, due to the complexities of some of these issues Richard Vann advises that the 'taxation of foreign investors is the last international taxation issue that a developing or transition country should seriously tackle'.[1384] While developing countries have various draft model tax conventions to choose from, the OECD Model Double Taxation Convention on Income and Capital has been by far the most influential model despite suggestions that the UN Model Tax Convention is more desirable for developing nations due to its preference for source country taxation.[1385] Given the constraints of time and scope, the discussion here would be confined to a few international taxation matters that directly impinge on the tax incentive policies of developing countries. The rest of this section (§**6.1**) considers these matters with a special emphasis on tax sparing provisions.

1382 David Holland and Richard J. Vann, 'Income Tax Incentives for Investment' in Victor Thuronyi (ed) *Tax Law Design and Drafting*, Vol.1, (IMF, Washington D.C: 1998), pp.986-1020.

1383 For a South African view, see Olivier and Honiball, *International Tax: A South African Perspective, op cit*. More generally, see Philip Baker, *Double Taxation Conventions and International Tax Law* (London, Sweet & Maxwell: 2005); Jonathan Schwarz, *Tax Treaties: UK Law and Practice* (London, Sweet & Maxwell: 2001); and Richard J. Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed) *Tax Law Design and Drafting*, Vol.1, *op cit*, pp.718-810.

1384 *Ibid*, p.810.

1385 Olivier and Honiball, *International Tax: A South African Perspective, op cit*, p.8. For a fuller critique on alternative model conventions from the perspectives of developing countries see: Kibuta Ongwamuhana *The Taxation of Income from Foreign Investments: A Tax Study of Some Developing Countries* (Kluwer Law and Taxation Publishers, Deventer: 1991).

6.1.2. Viherkenttä's 1991 Study

6.1.2.1. Introduction

One of the more comprehensive works in the literature on tax incentives policy issues for developing countries is a study by Timo Viherkenttä focusing on the relationship between income tax incentives for inward FDI in developing countries and the taxation of foreign income in capital-exporting countries.[1386] He examines the complexities created in international tax law by the interaction of typical developing country tax incentives and the tax treatment of foreign sourced income by the tax codes of 4 capital exporting developed countries, *viz.*: the USA, the UK, Germany and Finland. He considers the impact of these developed countries' tax codes on developing country tax concessions primarily by analysing the extent to which these codes 'wash-out' or 'pass-through' the benefit of the tax incentives directly to developed country resident parent companies, or indirectly through third country resident holding or investment companies, and (ultimately) to the shareholders of such parent companies resident in these capital-exporting countries.

Viherkenttä adopts a policy approach in his study, noting that it would be hard to envisage a study which could yield precise and reliable empirical results of frustration ratios for developing country tax incentives.[1387] However, Viherkenttä's study differs considerably from the present Thesis in several respects.[1388] Unlike the present Thesis, Viherkenttä's study adopts a wholly-FDI focused and capital-exporting country-centric approach which essentially examines the effects of dated,[1389] alternate policies of 4 industrialised countries.[1390] Indeed, he notes that as developing countries as a group exhibit a wide range of economic and social structures, legal systems and natural

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1386 Viherkenttä, *Tax Incentives in Developing Countries & International Taxation*, *op cit*.

1387 *Ibid*, p.230.

1388 There are certain similarities in both approaches. Both studies focus primarily on corporate as opposed to personal income tax. While, this Thesis, like his study, does not seek to set out a truly comprehensive presentation of the tax regimes of any countries, this Thesis provides a sufficiently comprehensive exposition of the Nigerian tax incentive regime to inform the applications of lessons from the South African and Kenyan experiences to the Nigerian situation.

1389 Viherkenttä's study was published in 1991.

1390 Viherkenttä, *Tax Incentives in Developing Countries & International Taxation*, *op cit*, p.5.

resource endowments, he makes certain necessary generalisations which must be approached with caution and which impose limits on his findings.[1391]

Viherkenttä emphasises issues raised by dividend distributions given his preoccupation with the financing side of FDI in developing countries. Conversely, this Thesis examines the other side of the coin: the tax incentive policies influencing investments in three developing countries, closely analysing the implications that lessons from two of the countries pose for the third. Nevertheless, to the extent that Viherkenttä's findings may inform the tax incentive policies of developing country policy-makers in Nigeria, South Africa and Kenya, this Researcher finds his study particularly useful in highlighting salient aspects of developing-developed country tax interactions that might otherwise be obscure.

6.1.2.2. **Summary of Viherkenttä's Main Points**

Viherkenttä examines the interaction between developing country tax incentives and various tax regimes including the exemption, foreign tax credit,[1392] tax sparing credit, deduction and reduced tax rate systems. He finds that evaluating the wash-out or pass-through of tax incentive benefits is a complicated affair largely dependant on the intricacies of capital-exporting countries' tax codes and the peculiar circumstances of the relevant enterprises. Various issues therefore arise for developing country policymakers to consider when granting tax incentives to foreign resident companies.[1393]

Where the capital-exporting country applies the **exemption system**, the issue is fairly straightforward and involves determining the extent to which the exemption is available.[1394] Viherkenttä demonstrates that for the *full-exemption*

[1391] *Ibid*, p.7. Viherkenttä also avoids the consideration of investment from one developing country to another; this Thesis takes a different approach in light of the significant investment South Africa makes to countries in the Sub-Saharan region.
[1392] Both direct and indirect credit methods.
[1393] Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.228-229.
[1394] *Ibid*, p.229.

method,[1395] there is a complete pass-through of tax incentive benefits attached to dividend repatriations. While there may be potential for a modest wash-out under the *exemption-with-progression* method,[1396] for both this type and the full-exemption specie, any wash-out will be marginal. Consequently the exemption system is relatively neutral to tax incentives and should raise few concerns for developing country policymakers.[1397]

Matters assume greater complexity where the capital-exporting country applies a variant of the **foreign tax credit** method[1398] which increases the likelihood that tax incentives would be washed-out on the repatriation of income to the residence country.[1399] The operation of the foreign tax credit may result in a corresponding increase in residence country taxation commensurate to the tax incentive granted by the source country. Should this occur the outcome is a perverse transfer of tax revenues from the source (developing) country's Treasury to that of the residence (developed) country.[1400] The foreign tax credit method features several varieties providing for ordinary credit, full credit, per-country or source-by-source limitations, foreign tax basket limitations and overall limitations.[1401] Certain types of limitation rules increase the risk of a

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[1395] Here, international double taxation is relieved by the residence/home country completely exempting from tax income derived from or capital situated in the source/host country: IBFD International Tax Glossary, *op cit*, p.160.

[1396] This is similar in function to the full exemption method, but while there is the recognition of source/host country income or capital, this is solely for the purpose of determining the taxation of income and capital from the residence/home country's tax base: *ibid*.

[1397] Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.62-63.

[1398] The foreign tax credit relieves international double taxation by permitting, unilaterally or pursuant to tax treaty provisions, taxes imposed on foreign-sourced income to be credited against domestic tax in on that income (often subject to a limitation): IBFD International Tax Glossary, *op cit*, p.100.

[1399] However, only income tax incentives would be affected and certain features of existing capital-exporting tax systems counter-act this tendency.

[1400] Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, p.72.

[1401] The *ordinary credit* method limits the credit to the lower of (a) the amount of foreign tax on the amount of domestic tax that would have ordinarily been imposed on the foreign-source income in the absence of the credit, or (b) the foreign tax on that income. Conversely, the *full credit* method extends the credit to domestic tax of any kind. Under *per-country* or *source-by-source limitation* methods, the credit is restricted to domestic income tax on income from a particular foreign country or source, respectively. Source-by-source limitations could use foreign tax credit baskets or wash-out of tax incentives.[1402] Viherkenttä extensively analyses interactions thrown up by alternative formulations of the foreign tax credit system and finds that the potential for wash-out varies with the precise formulation of the foreign tax credit in tax laws (or treaties) and depends on the circumstances of the relevant enterprise.[1403]

Further complications may arise where economic double taxation is relieved by the grant of **indirect credit** for the underlying tax levied on profits out of which dividends are distributed. Viherkenttä observes that the potential for a wash-out are enhanced where indirect credit systems possess certain features. Such features include gross-up for tax paid by the source country subsidiary's underlying profits;[1404] the 'pooling' method for determining the order in which dividends are deemed to be distributed from profits;[1405] and the use of current (as opposed to historical) rates for foreign currency translation over periods when the source country's currency is devalued.[1406]

However, the potential for wash-out under foreign tax credit systems could be mitigated by the deferral of tax liability[1407] where source country income is

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feature overall limitation devices: IBFD International Tax Glossary, *op cit*, pp.101,181.

1402 For instance, where regular tax in the source country is lower than that in the residence country, and income is derived from few activities or few other source countries, per-item and per-country limitation rules may wash-out tax concessions. The harder it is for companies to exploit averaging rules and use low-tax passive income to absorb excess credits from high-tax active operations, the more likely tax concessions would be washed-out. However, though the overall limitation method provides the greatest opportunity for averaging tax rates (as here, the maximum foreign tax credits are computed with reference to aggregate taxes paid and income derived from all source countries), Viherkenttä argues that this perversely reduces the incentive effect of source country tax concessions: Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.111-118,119.

1403 *Ibid*, p.128.

1404 *Ibid*, pp.100-101.

1405 Viherkenttä illustrates that under a LIFO/'rhythm method' utilised under the pre-1987 US tax regime, CFCs and offshore subsidiaries could preserve the benefits of tax incentives by skilfully timing income repatriations and profit distributions. Conversely, the pooling method introduced under the US 1986 Tax Reform Act would gradually recoup tax incentive benefits in tandem with profit distributions: *ibid*, pp.103-106.

1406 *Ibid*, pp.106-107.

1407 As a parent company's tax liability for income derived from a foreign subsidiary does not arise until the parent repatriates such income, parent company can postpone the neither repatriated immediately to the residence country nor subject to current taxation due to complex controlled-foreign-company (CFC) legislation.[1408] The use of 'soak-up' taxes[1409] could theoretically target tax incentives exclusively to countries whose exemption or foreign tax credit rules ensure the pass-through of tax incentive benefits. However, there are certain practical difficulties impeding the use of 'soak-up' taxes such as the challenge of conducting regular and accurate tax surveillance to identify circumstances where such taxes can prevent revenue transfers from source to residence countries.[1410] Finally, it may be the case that the benefits of subsidies and other non-income tax incentives may be preserved in circumstances where the wash-out rate for income tax incentives is high.[1411]

To a lesser extent Viherkenttä considers both the **deduction** and **reduced tax rate** methods. While the deduction method generally results in a partial wash-out, where the reduced tax rate method excludes the right to a credit or deduction, the potential for a total pass-through of tax incentive benefits is high.[1412] Viherkenttä's analysis of the **tax sparing credit** is considered below in **§6.1.3**. Nevertheless, he ultimately finds that '...an *immediate and complete wash-out of host country tax incentives granted to a locally incorporated subsidiary conducting active business seldom takes place* (but) ... when incentives are attached to various

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tax day by reinvestment in the source country or redeploying the capital in third countries. Deferral improves the source country subsidiary's cash liquidity and operates as an interest-free loan from the residence country depending on the length of deferral, the relevant discount rate and extent which income is reinvested in the source country: *ibid*, pp.91-96.

1408 However, Viherkenttä notes that these CFC rules are more likely to affect passive income from certain industries (e.g. financial services) routed through tax havens between related parties: *ibid*, pp.86-87.

1409 I.e. a tax or levy which is conditional on the availability of a foreign tax credit in another taxing jurisdiction. US tax rules disallow such taxes from being credited against US income tax: IBFD International Tax Glossary, *op cit*, p.371.

1410 Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, pp.123-125.

1411 As non-income tax incentives increase pre-tax source country income, the extent to which incentive benefits may be washed-out depends largely on the relevant marginal tax rate: *ibid*, pp.126-127.

1412 *Ibid*, pp.182,185.

items of income such as interest, royalties or portfolio dividends, a wash-out of incentives is a (sic) highly likely.'[1413]

6.1.3. The Tax Sparing Credit

6.1.3.1. Historical Development of Tax Sparing

Viherkenttä examines the impact of **tax sparing credits** (hereafter: TSCs) utilised to mitigate the potential wash-out of tax incentives as integral part of his analysis on the interactions between the tax codes of developed capital-exporting countries and their developing country treaty counterparts.[1414] TSCs are credits typically granted by residence countries under tax treaties for source country taxes notionally borne by dividends, interest, royalties and other kinds of income, in excess of the actual tax borne. TSCs affirm the economic sovereignty of the source country which grants tax incentives to non-resident investors.[1415] The operation of both foreign tax credit and exemption systems may potentially wash-out tax incentive benefits.[1416] TSCs ensure that tax incentives granted by source countries are not negated by residence taxation of the same income but rather, that non-residents obtain foreign tax credits for taxes 'spared' by source country incentives or have such taxes considered in satisfying conditions imposed under exemption systems.[1417]

TSCs were initially suggested by Professor Surrey in 1953 as a mechanism to promote British foreign investment through tax policy. While this proposal was initially rejected,[1418] TSCs later gained currency in UK legislation providing relief for taxes spared under source country incentives for economic

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1413 *Ibid*, p.231.
1414 *Ibid*, Chapter 6.
1415 IBFD International Tax Glossary, *op cit*, p.409.
1416 For the foreign tax credit method, this is self-evident as if credit is only given for source country taxes actually paid residence country taxation is increased to the extent that source country taxation is reduced by incentives. Similarly, where exemption systems require a certain level of taxation in the source country, if this threshold is not achieved due to source country incentives, residence country investors may be denied exemption benefits.
1417 ¶¶72-73, '2003 OECD Commentary on Article 23A & B, OECD Model Convention on Income and on Capital' in Kees van Raad (ed) *Materials on International and EC Tax Law*, Vol.1 (4th ed, Leiden, International Tax Centre/IBFD: 2004), pp.288-290.

development.[1419] Early attempts to include tax sparing provisions into the 1957 tax treaty between the US and Pakistan were rejected by the US Senate. However, despite the unwavering refusal of the US Senate to ratify tax treaties containing provisions for TSCs in this and all other US tax treaties, the draft tax sparing provisions under the US-Pakistan treaty influenced the design of tax sparing provisions on other treaties, particularly as TSCs became more popular in the 1960s/1970s.[1420] Viherkenttä observes that although TSCs are frequently considered in the context of treaties on the avoidance of double taxation, they actually operate to prevent income enjoying tax incentives from being fully taxed at all.[1421] Today, a great number of tax treaties between developed and developing countries (and indeed, among developing countries) feature tax sparing provisions. However, it appears that US opposition to TSCs resulted in the non-inclusion of draft tax sparing provisions in the UN Model Convention possibly undermining the Convention's impact and influence.[1422]

The Commentary on the OECD Model Convention highlights the following forms often assumed by tax sparing provisions.[1423] The residence country may allow a deduction of the amount of tax which the source country could have imposed under its general legislation but waived due to incentives. Alternatively, instead of relying on source country general legislation to determine the quantum of the phantom tax, the tax spared could be subject to limitations provided in the tax treaty such as those for dividends and interest. The residence country could also allow a matching credit deduction against residence taxation of an amount fixed at a higher rate. Then again, the residence country could elect to exempt income derived from the source state which has benefited from tax incentives.

1418 By the Chancellor of the Exchequer in 1957, following parliamentary debates on the issue in 1953 and 1956.
1419 §788(5) UK ICTA 1988; OECD, *Tax Sparing: A Reconsideration* (Paris, OECD: 1998), p.15.
1420 *Ibid*, p.16-17.
1421 Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, p.141.
1422 *Ibid*, pp.142-3.

6.1.3.2. The OECD's Reconsideration of Tax Sparing

The OECD has expressed reservations regarding the use of tax sparing by its member states. In a 1998 Report,[1424] the OECD's Committee on Fiscal Affairs considered reasons behind the growing reluctance by member states to grant tax sparing. In the new global economic framework, some emerging economies[1425] which traditionally were net capital-importers had now evolved into net capital-exporters. Such countries would increasingly approach treaty negotiations from the same perspective as traditional residence countries. Conversely, some OECD countries which were natural resource producers[1426] shared some common interests with developing source countries. As such, traditional distinctions underlying existing international tax arrangements which distinguished between OECD countries and other countries were potentially misleading.[1427]

Other concerns were expressed over the effectiveness of tax sparing as an instrument for promoting foreign aid[1428] and indeed, of tax incentives generally.[1429] Tax sparing was vulnerable to taxpayer abuse and caused significant harmful effects[1430] which were not only costly to both source and residence states but also difficult to detect or prevent. Finally, tax sparing

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1423 ¶74 OECD Commentary on Article 23A & B, OECD Model Convention on Income and on Capital, *op cit*, p.289.

1424 OECD, *Tax Sparing: A Reconsideration*, *op cit.*

1425 E.g. Russia, Chile, Taiwan and Singapore.

1426 E.g. Australia, Canada, Norway, the UK and the US.

1427 OECD, *Tax Sparing: A Reconsideration*, *op cit*, pp.10,21-22.

1428 Direct foreign aid was considered a more transparent means of assisting developing countries. Tax sparing could create incentives for rapid repatriation of profits and favour short-term investments in developing countries. Where source country incomes were reinvested, repatriated after an extended period of time or routed through averaging mechanisms like 'mixer companies', the potential for the wash-out of tax incentives was low. In these scenarios, the basic assumption underlying tax sparing was considered invalid: *ibid*, p.22-25.

1429 Several traditional criticisms of tax incentives were mentioned based on the experiences of OECD and transition economies (including: cost-benefit concerns; questions over targeting incentives; and the potential of tax incentives to complicate tax systems, encourage tax competition, undermine tax neutrality and encourage lobbying by special interests): *ibid*, pp.25-28.

1430 Such as transfer pricing abuses, conduit and routing schemes, artificially high tax rates and exacerbating administrative difficulties in monitoring tax sparing: *ibid*, pp.28-30.

could aggravate the problem of harmful tax competition utilised by tax havens to attract highly-mobile and tax-sensitive financial and other services.

Despite these criticisms, the Committee did not conclude that OECD member states should not grant TSCs. Rather, it encouraged member states to adopt a coherent approach to the issue and consider the legitimacy of reasons advanced by treaty counterparties seeking TSCs during negotiations. The Committee advised that tax sparing should only be granted where the treaty counterparty's state of economic development is objectively assessed to be considerably below that of OECD member states. Finally, guidance provided by certain 'best practices' would ensure that when tax sparing was provided, this would apply exclusively to genuine efforts to promote the economic development of source countries and not encourage harmful tax competition.[1431]

While the Committee raises many valid points, some of the premises on which its Report is based are not necessarily relevant from the perspective of the countries considered in this Thesis. The Report notes that certain non-OECD countries which in the past had been developing capital-importing countries could be more accurately described as middle-income, capital-exporting countries today. Of the countries examined in this Thesis, only South Africa can be classified as a middle income economy.[1432] Regrettably, Nigeria and Kenya still have relatively low levels of economic development. Given the significant income disparities within South Africa, the potential for economic development there is still considerable. Further, all three countries are also net capital-importers.[1433] Finally, none of these 3 countries have ever been classified as tax havens and relatively little investment is routed to these countries by highly-mobile and tax-sensitive financial and other services seeking solely to avoid or evade tax. As such, it would be appropriate to consider the Committee's conclusions bearing in mind the potential that the

[1431] *Ibid*, pp.41-43.
[1432] Indeed, of these three countries only South Africa appears to be on track to meeting the Millennium Goals by 2015.
[1433] Although, in relation to Sub-Saharan Africa, South Africa is a net capital exporter.

legitimate use of tax sparing might have for improving economic development in these study countries.

The Committee noted recent trends and **best practices** in designing tax sparing provisions.[1434] Defining precisely the scope of eligible tax incentives could minimise the risk inherent in general references to tax concessions. Static references could be made more flexible by automatically permitting minor modifications to incentive legislation to qualify for tax sparing if of substantially similar character to the agreed concessions. Alternatively, the treaty could fix the percentage of deemed tax paid at the ceiling rate provided in the treaty, at a level above or below this, at the rates set by source country's general tax law or at the lowest of these levels. Appropriate definitions were crucial in determining the categories of taxpayers and incomes which were eligible for TSCs. Certain conditions could limit TSCs to investments by companies or taxpayers with substantial holdings, promote active as opposed to passive investment in source countries and avoid abuses associated with providing TSCs for interest income.

The Report suggested that it was inappropriate to grant TSCs where income was ordinarily exempt under domestic or treaty law. Time limitations could be applied to each individual taxpayer to avoid the TSC from becoming a permanent concession. Alternatively, sunset clauses could limit the period a developing country could benefit from TSCs such that the advantage was phased out with the progressive economic development of the source country. Finally, the use of anti-abuse clauses and interpretative provisions could reduce inappropriate tax planning, counter illegitimate rewriting of contracts to exploit TSCs and enhance the effectiveness of controlled-foreign-company legislation.

Although Viherkenttä's study was conducted prior to the OECD Report, he illustrates various formulations of TSCs in treaties with the UK, Germany and

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[1434] OECD, *Tax Sparing: A Reconsideration*, *op cit*, pp.31-39.

Finland (all OECD countries). He finds that these countries' tax sparing provisions varied greatly in scope, design, methods of determining the creditable amount and degree of generosity.[1435] Such variety is a function of the bilateral negotiations between treaty counter-parties reflecting the idiosyncrasies of domestic tax laws, individual country preferences [1436] and indeed, the dynamics of the bartering process intrinsic in treaty negotiations. [1437] The next section highlights the diversity of tax sparing provisions in tax treaties between Nigeria, South Africa and Kenya on the one hand and both OECD and non-OECD member states on the other. As seen below, many of the OECD's Committee on Fiscal Affairs' best practices have been adopted in some of these treaties.

6.1.3.3. **Tax Sparing in Treaties with South Africa, Kenya & Nigeria**

South Africa frequently utilises tax sparing provisions in its treaties despite only being an OECD observer member. South African tax treaties typically use the deduction method for tax sparing provisions tied to source country domestic legislation designed to promote economic development. [1438] While most South African treaties follow this form, Olivier and Honiball observe that there are certain variations to this theme. [1439] Although most tax sparing provisions the authors review were reciprocal, a few were granted only in favour of South Africa [1440] or its treaty counterparty. [1441] Certain tax sparing provisions were extended to cover future source country laws,[1442] while others followed OECD best practice in that they were time-bound due to sunset

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[1435] Viherkenttä *Tax Incentives in Developing Countries & International Taxation, op cit,* pp.145-161.
[1436] For the foreign tax credit, exemption or deduction methods of eliminating international double taxation.
[1437] OECD, *Corporate Tax Incentives For Foreign Direct Investment,* OECD Tax Policy Studies No.4 (Paris; OECD: 1998), p.44.
[1438] Or indeed, to promote decentralisation: see South Africa's tax treaties with Romania (concluded on 12.11.93) and Taiwan (concluded on 14.02.94).
[1439] Olivier and Honiball, *International Tax: A South African Perspective, op cit,* p.290.
[1440] Article 23(6), South Africa-Ireland (Income) Tax Treaty concluded on 07.09.97; Article 23(2)(b), South Africa-Israel (Income) Tax Treaty concluded on 10.02.78.
[1441] Article 23(2) South Africa-Mauritius (Income) Tax Treaty concluded on 05.07.96.
[1442] *Ibid* (Mauritius). See also Article 23(3) South Africa-Romania (Income) Tax Treaty concluded on 12.11.93.

provisions stipulating expiry dates[1443] or would expire when the particular specific source country legislation to which they relate lapsed.[1444]

A perusal of 6 **Kenyan** tax treaties containing tax sparing credits reveals few similarities with South African practice.[1445] Unlike the South African trend towards reciprocity, of the 6 tax treaties reviewed by this Researcher all but 2 had provisions for TSCs couched unilaterally in favour of Kenya.[1446] Kenya's treaties with Denmark and Sweden share remarkable similarities: besides operating exclusively for Kenya's benefit, these tax sparing provisions make precise reference to specific Kenyan incentive legislation with a proviso extending the provisions to future incentives for promoting economic development that may be agreed by competent authorities of the contracting states.[1447] Both treaties have sunset clauses and provide for possible extensions beyond the initially stipulated ten years of operation. However, this period has only been extended by 14 additional years in the case of the treaty with Sweden.[1448]

Kenya's tax treaty with the UK has several unique features. Like the treaties with Denmark and Sweden, the UK treaty refers to particular sections of Kenya's income tax law. However, in line with OECD best practice its provisions curtail the extension of the tax sparing provisions to future incentives as agreed by the contracting states' competent authorities exclusively to those incentives which possess substantially similar character to those contained in specific Kenyan legislation with only minor modifications. A time-limitation also applies to exclude claims in respect of sources of

[1443] Article 23(6)(c), South Africa-Ireland (Income) Tax Treaty.
[1444] Article 23(2)(b), South Africa-Israel (Income) Tax Treaty.
[1445] Most of Kenya's tax treaties utilised the credit method of applying TSCs.
[1446] Only those with India and Zambia had reciprocal provisions: see Article 25(2) Kenya-India (Income) Tax Treaty concluded on 12.04.85 and Article XVI(4) Kenya-Zambia (Income) Tax Treaty concluded on 27.08.68.
[1447] Compare Article 25(4) Kenya-Denmark (Income and Capital) Tax Treaty concluded on 13.12.72 with XXII(4) Kenya-Sweden (Income and Capital) Tax Treaty concluded on 28.06.73. Kenya's treaties with India and Norway (concluded on 13.12.72) confer similar powers on competent authorities.

income arising ten years after the Kenyan tax incentives were first granted in respect of that source of income to prevent individual taxpayers from enjoying a permanent concession.[1449]

Dr. Gavin McEwen[1450] observed that Kenyan revenue authorities have not contacted their UK counterparts to update this tax sparing provision since the treaty was signed in 1974. Consequently, corporate income tax exemption under subsequently-enacted legislation (e.g. *EPZ Act 1990*) has led to a loss of credit for underlying tax when repatriated dividends are taxed in the UK clearly undermining the effectiveness of tax sparing as a tax policy tool.[1451]

Nigeria's treaty with the UK shares some of the distinctive features of the Kenya-UK Treaty.[1452] The tax sparing provisions favour only Nigeria and refer specifically to specific tax incentives provided in certain Nigerian tax laws.[1453] A similar proviso extends tax sparing provisions to other incentives only if agreed by competent authorities to be of a substantially similar character or slightly modified versions of the incentives specifically referred to. An identical ten-year limitation also applies from the time the incentives were first granted. However, the Nigerian tax sparing provisions feature a unique anti-avoidance rule to prevent their abuse by artificial transactions designed to exploit the availability of TSCs.[1454] Consequently, the Nigeria-UK treaty seems closer to OECD best practice than the Kenya-UK treaty.

1448 Apparently extended by an exchange of letters dated 23.03.87 and 11.05.87 between Kenya and Sweden.

1449 Article 26 Kenya-United Kingdom (Income) Tax Treaty concluded on 31.07.73.

1450 Gavin McEwen is an expert on Kenyan tax law and led PricewaterhouseCoopers' Kenyan tax team from 2001 to 2007.

1451 Statement by Gavin McEwen, former Head of Tax/Senior Tax Partner, PricewaterhouseCoopers, Kenya: (personal communication 12 September, 2007).

1452 Article 22(2) Nigeria-United Kingdom (Income) Tax Treaty concluded on 09.06.87.

1453 The references are to the 'pioneer industry' tax incentives and certain finance-related incentives tied to loans to certain economic sectors.

1454 Article 22(5) preclude transactions giving rise to profits which 'are not such as might be expected in a bona fide commercial transaction' or whose main or collateral objective is to obtain the TSC.

Nigeria's tax sparing treaty provisions with Canada are quite similar to those with the UK except for the absence of the special anti-avoidance rule.[1455] Nigeria's treaties with Pakistan,[1456] the Philippines,[1457] Romania[1458] and the Slovak Republic[1459] have much simpler tax sparing provisions which make general references to domestic tax incentive laws.[1460] While those with Pakistan and the Philippines are reciprocal, the Romanian and Slovakian treaties benefit only Nigeria. Nigeria's treaty with Sweden[1461] (an OECD member country) has more complicated and very specific tax sparing provisions. These provide targeted TSCs for Nigerian taxes spared on investments by Swedish permanent establishments in specific sectors considered to promote economic development.[1462] The tax sparing provisions feature unique matching credits set at specific ceilings for royalties[1463] and other income.[1464]

Both parallels and distinctions may be drawn between the tax sparing provisions in Nigeria's treaties with France[1465] and the Netherlands.[1466] Both are similar in favouring only Nigeria. However, while the Dutch promote FDI in Nigeria, the French support more generic economic, industrial and commercial development. Furthermore, the Dutch treaty is limited to incentives relating to interest, dividends and royalties, but the French provisions are slightly more

1455 Article 23(2) Nigeria-Canada (Income) Tax Treaty concluded on 04.08.92.
1456 Article 23(2) Nigeria-Pakistan Tax Treaty concluded on 10.10.89.
1457 Article 23(4) Nigeria-Philippines (Income) Tax Treaty concluded on 30.09.97.
1458 Article 23(3) Nigeria-Romania (Income) Tax Treaty concluded on 21.07.92.
1459 Article 22(2)(b) Nigeria-Slovak Republic (Income) Tax Treaty concluded on 31.08.89.
1460 Of these 4 countries, only the Slovak Republic is an OECD member country. It is useful to note that the Nigerian-Slovak treaty was concluded before the Slovak Republic joined the OECD in December 2000.
1461 Article 22(2) Nigeria-Sweden (Income) Tax Treaty concluded on 18.11.04.
1462 The permanent establishment's activities must have been conducted in Nigeria and relate to investments in exports, mining, telecommunications, manufacturing and industry, energy, agriculture or tourism.
1463 A 5% matching credit is added (or substituted) for Nigerian withholding taxes imposed (or waived, respectively), on gross royalty receipts enhancing TSCs.
1464 Dividends paid by Nigerian companies to Swedish companies are tax exempt. Other income receipts enjoy TSCs set at 15% irrespective of the relevant Nigerian domestic tax rates. Despite OECD best practice of not granting TSCs for income exempt in residence countries, it appears that a TSC of 15% may be granted for dividend income if earned from certain active investment activities.
1465 Article 23(2) Nigeria-France Tax Treaty concluded on 27.02.90.
1466 Article 23(3) Nigeria-Netherlands Tax Treaty concluded on 11.12.91.

restrictive and do not apply to dividends.[1467] Both treaties limit TSCs to the lower of rates agreed in the relevant treaty articles and those normally imposed under general Nigerian tax law. Unlike the French treaty, the Dutch treaty features a sun-set provision though the initial ten-year period could be extended by the mutual agreement procedure.

6.1.3.4. Practical Implications for Developing Country Policymakers

One can discern the clear trend of OECD countries adopting OECD best practices in the design of tax sparing provisions in their treaties with Nigeria, Kenya and to lesser degree, South Africa.[1468] However, the extent to which developing country tax policymakers consider the strategic motivations of OECD member states in tax sparing negotiations is unclear. Viherkenttä argues for greater consideration of international tax interactions by policymakers of both developing and developed countries *vis-à-vis* the grant and facilitation (or frustration) of tax incentives when formulating tax policies. In particular, he urges developing country policymakers to examine key, critical tax treaty provisions[1469] with their most important trading partners especially where these (developed) countries adopt any variant of the foreign tax credit method as such analysis could prove vital during tax treaty negotiations.

Viherkenttä's research further suggests that though developing country negotiators may place a premium on exemption systems or TSCs, generally preferring these methods to the foreign tax credit system, this preference may be misplaced. Much of the consequences for the flow-through or wash-out of tax incentive benefits depend on the precise circumstances surrounding the relevant taxpayer and it may well be that 'variations relating to each individual taxpayer's circumstances or the detailed formulation of the relevant provisions

[1467] Nigeria's treaty with Belgium also provides TSCs only for dividends, interest and royalties but its provisions are simpler and unlike those of the French and Dutch treaties: Article 23(3) Nigeria-Belgium (Income) Tax Treaty concluded on 20.11.89.
[1468] South African treaties with OECD member states (e.g. Canada, Germany, the Netherlands, the UK and the US) tend not to feature tax sparing provisions.
[1469] E.g. limitation rules, restrictions on deferral, particular provisions conducive to tax planning opportunities for foreign investors from major trading partners.

within each method often outweigh the differences *between* methods.'[1470] To underscore this point, Viherkenttä notes that

> ... (the foreign) tax credit does not quite live up to its bad reputation as the obstructor of developing countries' national sovereignty in their tax policy. In the absence of empirical studies, it is still impossible to assess the actual effects in aggregate quantitative terms. What must be emphasised is that least-developed country (hereafter: LDC) policy-makers should gather information on the crucial features of the foreign tax credit systems prevailing in their most important countries of incoming investment.[1471]

Consequently, he argues that developing country negotiators should not concede vital advantages to secure the application of the exemption system or indeed, TSCs without giving due consideration to these issues.[1472]

6.1.3.5. **Focus Group Perspectives from the Nigerian Field Trip**

This Researcher presented some of these concepts to personnel of FIRS' Tax Policy Research and Development Department at a Focus Group Discussion organised during the Nigerian Field Trip.[1473] Although tax sparing was but one of many issues involved in tax treaty negotiations, tax sparing was relevant *vis-à-vis* emerging trading partners like China.[1474] If unduly generous tax incentives were provided in the absence of tax sparing provisions, there was the potential risk that concessions would be 'washed-out' and captured by, say, Chinese tax authorities resulting, perversely, in aid-in-reverse.[1475] This Researcher presented the following hypothetical investment scenario to illuminate these issues during the Discussion.[1476]

1470 Viherkenttä *Tax Incentives in Developing Countries & International Taxation*, *op cit*, p.235.
1471 *Ibid*, p.139.
1472 *Ibid*, p.232.
1473 The Focus Group Discussion was conducted on 07.02.07 at the FIRS Headquarters, Abuja, Nigeria. Whereas tax treaty negotiations are usually led by the Ministry of Finance, FIRS traditionally has provided technical support. It remains to be seen if this role remains with FIRS or becomes part of the mandate of the Ministry of Finance's emerging Fiscal Department.
1474 E.g. as noted in §**3.2.5.2** above, the N2billion Lekki EPZ in Lagos is being financed primarily by Chinese investors.
1475 Nigeria's treaty with China does not presently provide for tax sparing: see Article 23 Nigeria-China (Income) Tax Treaty concluded on 15.04.02.
1476 However the actual operation of international taxation has been greatly simplified in this example to improve clarity.

BASE CASE: NORMAL NIGERIAN & CHINESE TAX; NO TSCs

Assume that a Chinese company (C Coy) invests US$4billion in a Nigerian production sharing contract (PSC) subsidiary (N Coy) earning an annual 25% rate of return (ROR). All income net of Nigerian tax is repatriated as dividends. Nigerian tax comprises: (1) 50% PSC tax on corporate profits under §3, Deep Offshore/PSC Act 1999[1477] *& (2) 10% withholding tax on outbound dividends. There is no tax treaty between Nigeria & China providing relief for double taxation or tax sparing. Chinese tax at 10% is levied on inbound dividends.*

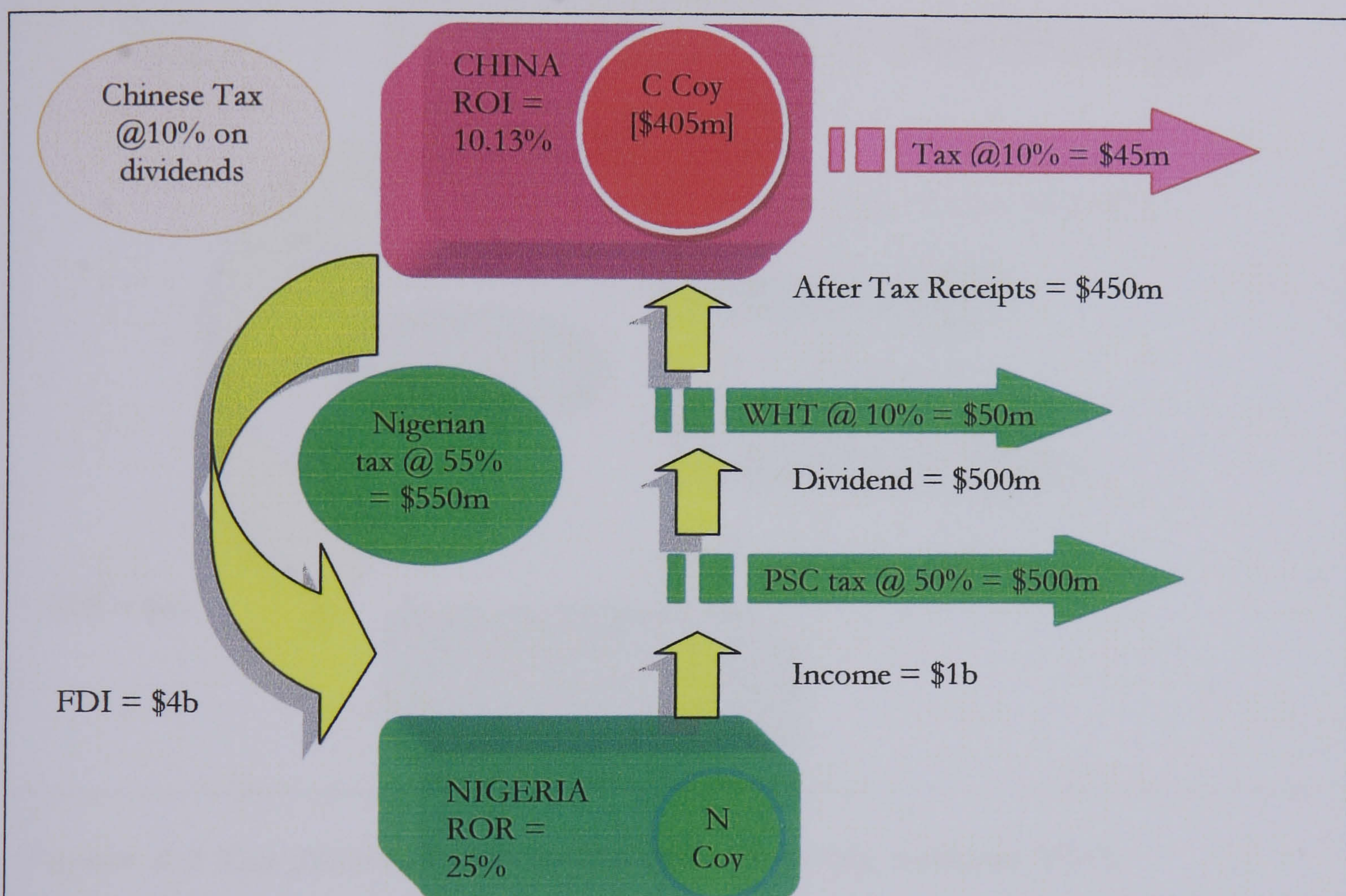

Figure 6.1 Normal Tax & No TSCs

In this scenario, the Nigerian Treasury receives US$550million in aggregate taxes implying an effective tax rate of 55%. The Chinese Treasury's tax take is US$45million on repatriated dividends. C Coy's investment in N Coy yields an after-tax return on investment (ROI) of 10.13% (i.e. ROI = US$405million/4billion) less than half of the pre-tax ROR of 25% actually earned by N Coy (i.e. ROR = US$1billion/4billion).

[1477] See **§3.2.2.1.4** of this Thesis.

CASE II: TAX HOLIDAYS UNDER OGEPZ ACT 1996 WITHOUT TSCS

Assume further that N Coy is located in Nigeria's Onne/Ikpokiri EPZ & entitled to indefinite tax holidays from PSC tax & withholding tax under the OGEFZ Act 1996. [1478] *Consequently, Nigerian tax is 0%. There is a tax treaty between Nigerian & China which provides foreign tax credits, but credit is only given for taxes actually paid in source countries. There is no tax sparing for notional taxes. All other assumptions are unchanged.*

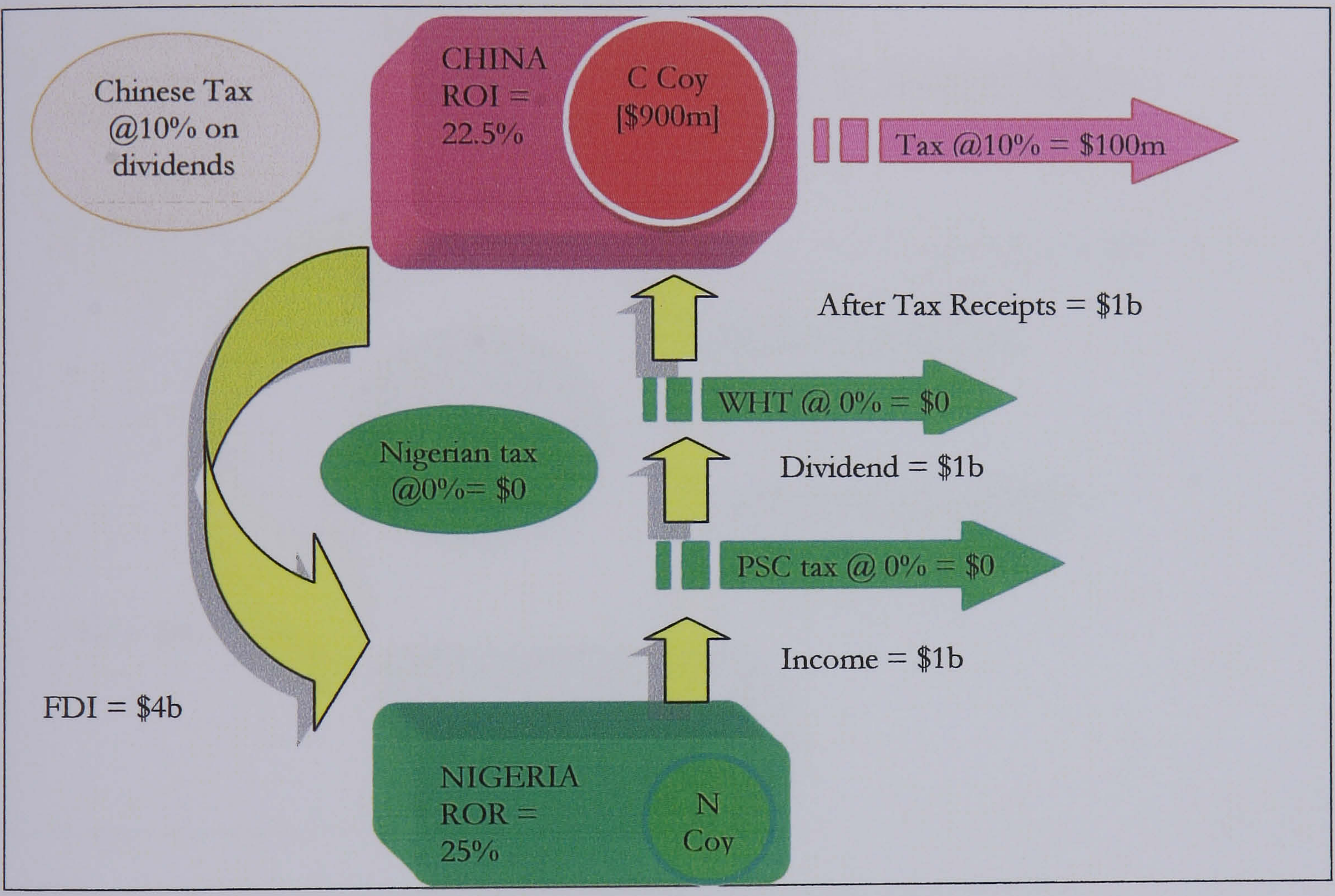

Figure 6.2 Tax Holidays under OGEFZ Act 1996 without TSCs

As the tax treaty between Nigeria & China does not provide for tax sparing credits (TSCs) in respect of Nigerian tax waived, Chinese tax remains at 10% on inbound dividends. Nigeria has forgone US$550million in taxes, US$100million of which has been captured by the Chinese Treasury whose tax take increases by US$55million over the Base Case. The outcome is perversely aid-in-reverse: Nigeria providing a transfer of revenues to China. C Coy also benefits as its ROI has more than doubled from 10.13% to 22.5% (i.e. ROI = US$900million/4billion). The Chinese Treasury & C Coy both gain at Nigeria's expense.

[1478] See §3.2.2.1.7 of this Thesis.

Case III: Tax Holidays under OGEPZ Act 1996 with TSCs

Finally, assume that the tax treaty between Nigeria & China provides a full tax sparing credit (TSC) in respect of all taxes waived by Nigeria. As N Coy is entitled to indefinite tax holidays under the OGEFZ Act 1996, Nigerian tax is 0%. Due to the TSC, Chinese tax on repatriated dividends is also 0%. All other assumptions remain unchanged from Case II.

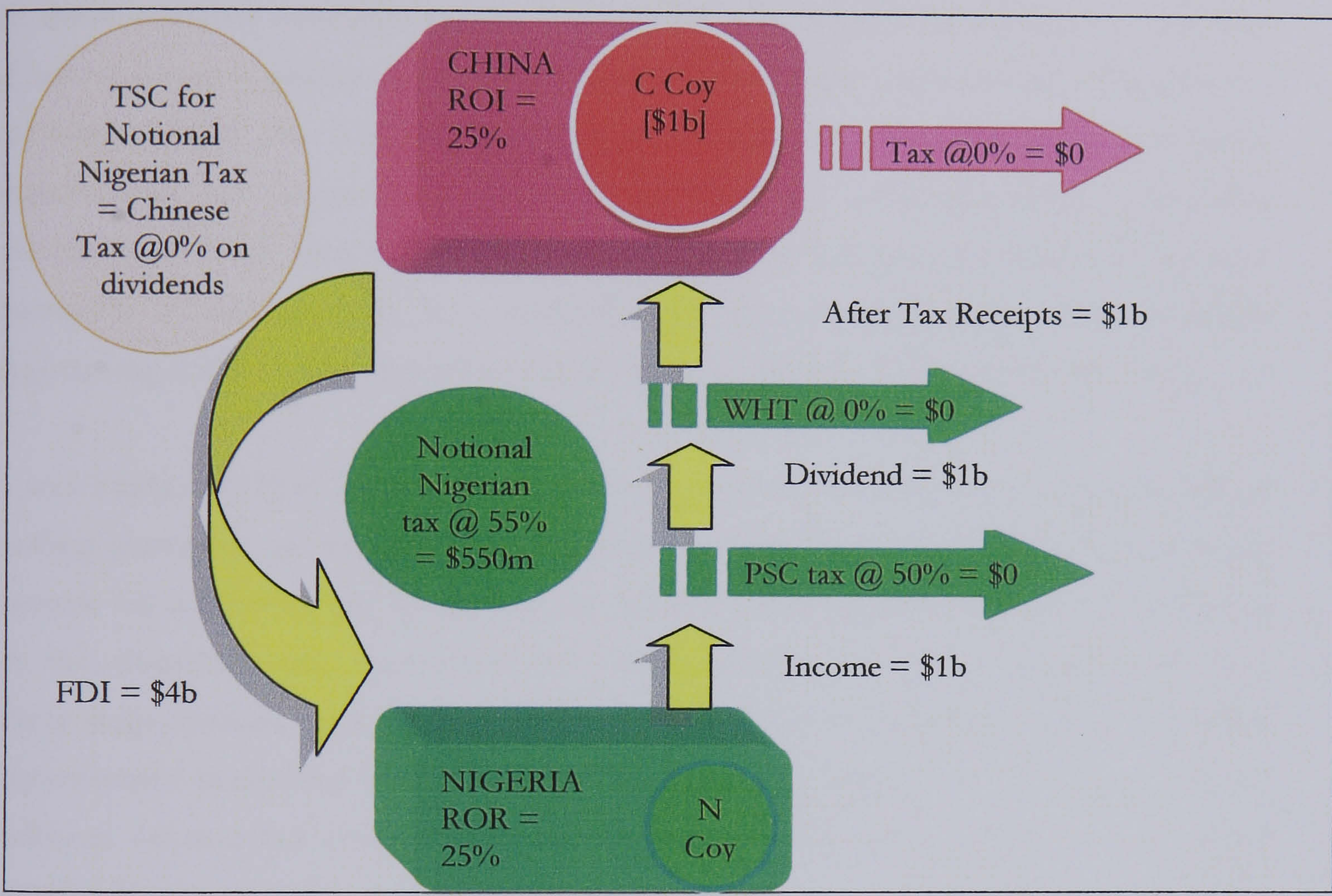

Figure 6.3 Tax Holidays under OGEFZ Act 1996 with TSCs

The Chinese Treasury spares from tax dividends received by C Coy from N Coy under this simplified foreign tax credit/tax sparing credit system. This preserves Nigerian tax incentive benefits. Nigeria has waived US$55million in taxes but China has respected this concession by providing a corresponding TSC. C Coy is the sole beneficiary of the concession: its ROI now equals the actual 25% ROR earned by N Coy. C Coy has incentives to reinvest earnings in N Coy or otherwise apply its dividend receipts. (Of these three scenarios, the worst outcome for the Nigerian Treasury occurs in Case II which corresponds to the current reality under the Nigerian & Chinese Tax Treaty).[1479]

[1479] See Article 23 Nigeria-China (Income) Tax Treaty concluded on 15.04.02.

It became quite apparent during the Discussion that while it was accepted these international tax law interactions were vital issues that should be carefully considered from both residence and source state perspectives when negotiating tax treaties in general and tax sparing provisions in particular, these matters were often not thoroughly evaluated in actual treaty negotiations. Specifically, FIRS' Tax Policy Research & Development Department had not yet done detailed scenario analyses of model tax treaties and domestic tax laws of treaty counter-parties in the context of past treaty negotiations. Nigeria did not adopt either the UN or OECD Model Convention as a template for treaty negotiations but adopted a flexible approach in selecting which particular articles from both Model Conventions would best advance its national interest. However, it was unclear if a specific set of strategies were adopted when negotiating with OECD member countries as opposed to non-OECD states.

It was explained that normally tax treaties were concluded with Nigeria's major trading partners, in which circumstances the Nigerian negotiating team would embark on an exchange of model tax treaties and gather relevant information on the domestic tax provisions of counterparty. All these analyses go into treaty negotiations to be addressed in conjunction with issues raised by other departments including the Ministries of Finance, Justice and Foreign Affairs. Political or non-tax issues were sometimes given greater weight in tax treaty preparations and negotiations.[1480] However, there were circumstances where the negotiating counterparty had refused to accede to certain requests (such as the grant of TSCs) causing negotiations to stall. Finally, while some consideration of the content of the domestic tax laws of the treaty counterparty was conducted, there was no evidence to suggest that there was a policy flow in the reverse direction in that the Nigerian negotiating team's experiences were reflected in broader Nigerian tax policy. This lapse heightens the risk that there could be a proliferation of Nigerian tax incentives despite a trend among

1480 Reference was made to treaty negotiations between Nigeria and an Islamic state with which there was relatively modest economic trade possibly motivated by purely political reasons.

treaty counterparties to grant tax sparing only subject to stringent conditions or possibly not at all.

The implications of the foregoing findings for Nigeria's tax incentive policies are further considered in Chapter 7 of this Thesis. However, it is clear that Nigeria could benefit significantly from adopting Viherkenttä's advice to gather and analyse critical information on the salient aspects of the foreign tax credit systems prevailing in their most important countries of inward investment in determining which strategies to adopt in negotiating tax sparing and other treaty provisions.

6.1.4. **Outline of the Subsequent Sections**

§**6.1** has considered some international tax law issues that have a significant impact on the policies and design of developing source country tax incentives and double taxation treaty strategies. §**6.2** highlights some influences that treaties promoting regional integration initiatives may .have on the tax incentive policies of Kenya, South Africa and Nigeria. This brief overview is complemented by a more extensive consideration in §**6.3** and §**6.4** of the more significant influence of three international organisations on the fiscal incentive policies of South Africa, Kenya and, to a greater extent, Nigeria.

6.2. REGIONAL INTEGRATION & TAX COMPETITION ISSUES

6.2.1. Introduction

There are few instances of the significant effect of regional integration treaties, laws and regulations on tax incentive policies that are as profound as the imposition of state aid rules on the member states in the European Community (or EC). In his study, Raymond Luja pays particular attention to the constraints imposed by these rules and those arising from the World Trade Organisation's subsidies regulations on EC member states.[1481] While it is conceded that pan-African regional integration is a distant prospect when compared to the advances made in the EC, African regional blocs, like many other regional unions, look closely at the EC's example. As such, while not directly relevant, some of the lessons from the experiences of EC member states may increasingly prove to be important from an African perspective.

6.2.2. African Regional Integration Arrangements

African political, economic and cultural unity ranks high among current regional priorities. However, it appears that the majority of African Union leaders prefer a more gradual integration initially focused on strengthening regional economic blocs as the foundation for future, pan-African political integration.[1482] There are hordes of regional integration treaties in Sub-Saharan Africa promoting regional economic bourses.[1483] Nigeria, South Africa and Kenya are the largest economies in their respective regions and play significant leadership roles in the ECOWAS, SADC/SACU and EAC/COMESA regional blocs. However, very few of these regional integration arrangements (hereafter: RIAs) are actually effective at promoting economic growth. The tendency of African RIAs to constitute 'stumbling blocks' to (and not 'building blocks' for) regional free trade may be due to limited patterns of trade, high dependence on

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1481 Luja *Assessment & Recovery of Tax Incentives in the EC & the WTO*, *op cit*.

1482 'African governments opt for time on single government', *Nigerian Guardian Newspapers* article, 5th July 2007 accessed at <http://www.guardiannewsngr.com/news/article04> on 05.07.07.

1483 Evidently, West Africa boasts of 30 of such treaties: AfDB, *African Development Report 2000: Regional Integration in Africa*, (Oxford University Press, New York: 2000) p.135.

primary products, suboptimal inter-country trade and challenges with increasing the volume and variety of goods and services.[1484]

ECOWAS was established in 1975 by Nigeria and 15 other West African countries and presently has a market of 211million people with a combined GDP of US$82billion.[1485] Despite visionary plans to establish a common market, introduce a single currency and harmonise agricultural, industrial, infrastructural, monetary, environmental and other national policies,[1486] very little progress has been made on most fronts.[1487] The disappointing progress of ECOWAS can be contrasted with the relative success of SACU, which is the continent's oldest customs union. SACU has developed since 1898 under South Africa's leadership and features a strong common monetary area, central customs organisation, good transport linkages and sound outward-looking trade policies.[1488] SACU has also been instrumental in the development of the wider Southern African Development Community (SADC).[1489]

Kenya's economic dominance over Uganda and Tanzania was one of the reasons that led to the demise of the original East African Community (EAC) in 1977.[1490] However, the union was revived in July 2000 and currently features a customs union (EAC CU) although proposals exist to establish a political union by 2013.[1491] Integration has been strengthened this time around by the attenuation of Kenya's regional industrial supremacy and the introduction of a declining tariff regime. Dual RIA memberships occasionally create overlapping commitments,[1492] but they also increase prospects for broader, pan-African economic integration.

1484 *Ibid*, pp.127,162-165.
1485 *Ibid*, p.161.
1486 Articles 3-5, Revised Treaty of the Economic Community of West African States (E.C.O.W.A.S.) concluded 24.07.93: African Tax Systems: Section E, (Amsterdam; IBFD: 1999), pp.14-15.
1487 AfDB, *African Development Report 2000*, *op cit*, pp.161-162.
1488 *Ibid*, pp.149-152.
1489 *Ibid*, p.154.
1490 *Ibid*, p.157.
1491 UNCTAD-ICC, *An Investment Guide to East Africa* (UN, New York/Geneva: 2005) p.1.
1492 Kenya and Uganda belong to COMESA; Tanzania is a member of SADC.

6.2.3. **Fiscal Integration & African RIAs**

There has been some degree of fiscal cooperation within the EAC, SACU and ECOWAS, particularly *vis-à-vis* maintaining a common external tariff (hereafter: CET). In this respect the **EAC** has been very active at harmonising fiscal policies. Corporate taxes and the highest personal income tax bands are uniform at 30%. VAT rates cluster between 16% (Kenya) and 20% (Tanzania)[1493] although these (and excise duties) are to be further harmonised to reduce the scope for regional tax competition. A tri-band CET[1494] is complemented by declining rate internal tariffs stilted in favour of Tanzanian and Ugandan exports into Kenya.[1495] More fundamental proposals seek to **harmonise and rationalise tax incentive policies** and facilitate the promotion of export-oriented investment within the region.[1496] Under the EAC Customs Union Protocol, common policies and regulations are to be provided for duty-drawback schemes,[1497] duty/VAT-remission schemes,[1498] manufacturing-under-bond programmes[1499] and EPZs.[1500]

A key aspect of the **SACU's** trade liberalisation is the Free Trade Area[1501] and CET applied on goods imported into the SACU.[1502] The CET is administered by the South African Board of Tariffs and Trade which determines the rates of excise duties.[1503] Under the Treaty of Windhoek, one of the means of attaining the objectives of regional integration is the harmonisation of political and socio-economic policies.[1504] Trade integration has been pursued through the

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1493 Uganda: 17%.
1494 This CET features rates at 0%, 10% and 25%.
1495 Exports to Kenya are zero-rated. Exports from Kenya to these countries are subject to a declining tariff to be phased out over 5years: UNCTAD-ICC, *An Investment Guide to East Africa*, pp.27-29.
1496 *Ibid*, pp.50-51. See generally Part F, EAC Customs Union Protocol.
1497 Article 26, *ibid.*
1498 Article 27, *ibid.*
1499 Article 28, *ibid.*
1500 Article 29, *ibid;* cf. Easson *Tax Incentives for Foreign Direct Investment*, *op cit*, p.217.
1501 Ensuring the free movement of domestic goods within the common customs area: Article 18, Southern Africa Customs Union Agreement of 2002.
1502 Articles 19-26, *ibid.*
1503 AfDB, *African Development Report 2000*, *op cit*, p.149.
1504 Article 1(2), Declaration and Treaty of the Southern African Development Community.

harmonisation of fiscal polices. In relation to **tax incentives**, member states are required to achieve a common approach to the treatment and application of incentives.[1505] A fiscal framework and certain guidelines were to be established to evaluate the effectiveness of tax incentives within the SADC, the resultant impact of revenue costs to member states, the effectiveness of tax incentives in the absence of tax sparing arrangements within double taxation treaty networks and the impact on tax burdens and administration within SADC.[1506]

It is unclear how far **ECOWAS** has progressed with the harmonisation of regional tax incentive policies.[1507] However, the CET has been the major instrument for trade liberalisation and economic integration within ECOWAS. One stumbling block to this process has been Nigeria's notoriously high import tariffs. Given the size of the Nigerian economy relative to the region, such tariff barriers to entry are significant. On a positive note, Nigeria recently rationalised its tariff regime by harmonising it with the ECOWAS CET.[1508] These new tariffs cluster mainly around 4 bands: basic necessities (0%), raw materials (5%); plant and machinery (10%); and consumer goods (20%). However, a protectionist 5th band (50%) still remains in force till January 2007 and was to be reviewed in January 2008. This band protects agriculture, which remains the most sheltered sector with average tariff protection set at levels 50% higher than that of the industrial sector. Import levies were increased on cigarette and rice imports to maintain pre-reform levels of protection for local agricultural production.[1509] As such, fiscal competition based on tariff rates still remains an outstanding issue within the ECOWAS bloc.

1505 Article 4(1), SADC Memorandum of Understanding on Co-operation in Taxation.

1506 *Ibid*, Article 4(4)&(5).

1507 Under the original 1975 ECOWAS Treaty, specific reference was made to the harmonisation of industrial incentives and development plans (Article 30). This provision is absent in the revised 1993 ECOWAS Treaty.

1508 Total tariff bands dropped: from 19 to 5 bands; from a maximum rate of 150% to 50%; from an un-weighted average tariff of 28.6% to 12.1% (from 51% to 16.4% for agricultural products and 24.8% to 11.4% for industrial products).

1509 See Box 1: 'Nigeria: The October 2005 Tariff Reform', FGN; First Review under Policy Support Instrument Staff Report; Staff Statement, Press Release on the

6.2.4. Harmful Tax Competition or Fiscal Cooperation?

One recent initiative to promote regional fiscal policy harmonisation was a study on tax incentives commissioned by SADC Tax Subcommittee.[1510] In this monograph on fiscal incentives, Bruce Bolnick considers the economics of harmful tax competition in relation to the SADC region. Bolnick examines the relevance of the OECD's harmful tax competition initiative[1511] to SADC by drawing parallels between the OECD's definition of tax havens[1512] and harmful preferential tax regimes, [1513] and SADC's concept of harmful tax competition[1514].[1515]

The OECD's 1998 Report considers tax havens and harmful preferential tax regimes as potentially harmful because they distort financial and real investment flows, undermine the integrity and fairness of tax structures, discourage compliance by all taxpayers, warp the desired mix of taxes and public spending, cause undesired shifts of the tax burden to less mobile tax bases, and increase administrative costs and compliance burdens (respectively) for revenue authorities and taxpayers. [1516] However, none of the countries studied in this Thesis was listed among offensive tax regimes in the OECD's

Executive Board Discussion, & Statement by Executive Director for Nigeria, IMF Country Report 06/180; March 31, 2006.

[1510] Bruce Bolnick/Nathan-MSI Group; *Effectiveness and Economic Impact of Tax Incentives in the SADC Region (Technical Report)* (Arlington; Nathan Associates Inc: February 2004).

[1511] OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris, OECD: 1998).

[1512] Essentially, regimes able to finance their public services with no or nominal income taxes, which consequently hold themselves out as attractive locations for non-residents to escape residence country taxation. Tax havens lack mechanisms for the effective exchange of information; transparent legislative, legal or administrative procedures; and requirements stipulating that economic activities be substantial to qualify for minimal tax treatment: *ibid*, pp.20,22-24.

[1513] Regimes which raise significant revenues from their income tax but whose tax systems have features (e.g. no or low effective tax rates on relevant income, ring-fencing provisions, lack of transparency and absence of effective exchange of information procedures) which lead to harmful tax competition: *ibid*, pp.20,22-24. See also IBFD International Tax Glossary, *op cit*, p.204.

[1514] SADC equates harmful tax competition to tax systems designed to erode the tax bases of other jurisdictions and attract investments and savings originating elsewhere, and so facilitating the avoidance of taxes in other jurisdictions: Article 1, SADC Memorandum of Understanding on Co-operation in Taxation.

[1515] Bolnick *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, *op cit*, pp.6-1 – 6-4.

[1516] OECD, *Harmful Tax Competition: An Emerging Global Issue*, *op cit*, p.16.

2000 Report.[1517] Indeed, there are some arguments suggesting that tax competition is potentially beneficial in forcing governments to provide the most attractive yet cost-effective investment environment. Investors should be at liberty to choose between high-tax/high public-expenditure states on the one hand, and low-tax/low public-expenditure states on the other.[1518]

Bolnick expresses concerns about the negative fiscal externalities that tax competition imposes on neighbouring countries by promoting perverse outcomes such as those obtained under the 'prisoner's dilemma' and 'winner's curse' scenarios.[1519] He notes the well-documented instance of South Africa losing out to Namibia in a tax incentive contest over Malaysian Ramatex's R1billion investment in a new textile production facility.[1520] However, he notes 'most tax incentives in the SADC region appear to be driven by a legitimate desire to create an attractive investment environment, rather than a deliberate intent to deprive other Member States of investment and revenue.'[1521]

This view was corroborated by this Researcher during a Teleconference with **Martin Grote**, the South African National Treasury's Chief Tax Policy Adviser and Tax Specialist.[1522] Grote noted that since 2006 there was a general proliferation of tax incentives among the SADC community despite Bolnick's generally adverse findings on tax incentives in the region. The only exceptions to this trend were South Africa and Mauritius (which is apparently scaling down the scope and extent of its tax incentive schemes). Regrettably, other SADC countries were increasing the number of tax incentives they grant. However, in Grote's opinion this development was not so much a case of tax competition among SADC countries but rather, because these countries'

[1517] OECD, TOWARDS GLOBAL TAX CO-OPERATION, Report to the 2000 Ministerial Council Meeting, June 2000 (Paris, OECD: 2000).
[1518] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.224.
[1519] See further: Bolnick, *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, *op cit*, pp.6-4 – 6-8.
[1520] *Ibid*, Exhibit 6-2.
[1521] *Ibid*, p.6-11.
[1522] The Teleconference was held on 29.06.07 from 07.00hrs to 07.17hrs GMT.

policymakers persisted in the belief that tax incentives are necessary to attract FDI and ensure their economies remain attractive investment locations.

6.2.5. **Concluding Comments**

The foregoing discussion demonstrates that the prospects for severe tax incentive competition among countries within the ECOWAS, SACU/SADC and EAC/COMESA economic blocs appear to be low.[1523] Modest regional arrangements exist to encourage fiscal cooperation on tax incentives but the actual implementation of these arrangements is mixed across these regions. As the study countries play significant leadership roles within their respective bourses, their efforts to enhance fiscal integration have great impact on the progress of these initiatives. While South Africa's role within the SACU/SADC region has been progressive, Nigeria has been quite reluctant to harmonise its CET due to national economic priorities. However, as economic and political integration progresses among the continent's regional blocs, the prospect for wider, pan-African fiscal cooperation on tax incentives should improve.

The rest of this Chapter (*viz.*, §**6.3** and §**6.4**) examines the pervasive influence of international constraints on tax incentive policies imposed by the global trade order brokered by the World Trade Organisation, and the global financial architecture regulated by both the International Monetary Fund and the World Bank. The nature, incidence and rationale for these constraints are examined from the perspective of developing countries and in light of criticism levied against the so-called 'unholy trinity' of the World Trade Organisation, the International Monetary Fund and the World Bank.[1524] The implications of these constraints for the politics, 'ownership' and sustainability of fiscal incentives reforms are considered next.

[1523] Relative to instances of intra-country and intra-regional incentive competition in the Americas, Central Europe and South-East Asia: Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, Chapter 4.

[1524] Richard Peet *et al*, *The Unholy Trinity: The IMF, World Bank and WTO* (Zed Books, London: 2003), Chapter 6.

6.3. INTERNATIONAL TRADE LAW & POLICY ISSUES

6.3.1. Introduction

In all treaty situations where sovereign states cede control over policies otherwise within their domain, issues of defensive and affirmative sovereignty arise.[1525] Easson notes that while in theory fiscal sovereignty is an undeniable aspect of a sovereign state's liberties, there are practical internal and external constraints on the use of tax incentives by any sovereign state as a tool to promote of economic development.[1526] Developing nations grapple with basic revenue constraints as well as political and economic influences which impose conditions on the design and administration of investment incentive policies. Domestic political pressure over the targeting of these policies to foreign or local investors may be a major consideration. However, developing countries are also influenced by more international pressures and there are few areas of international law that provoke more concerns for fiscal incentive policy than international trade law.

6.3.2. The Disciplines of the World Trade Organisation & International Trade Constraints

6.3.2.1. Introduction

The World Trade Organisation (hereafter: WTO) was established in 1995 by the Uruguay Round of negotiations[1527] as the successor organisation to the international trade arrangements established under the General Agreement on Tariffs and Trade (hereafter: GATT). Its purpose is to manage world trade liberalisation and serve as a multilateral forum for governments to settle disputes arising out of trade agreements. The WTO acts to improve the flow of trade between member countries through negotiated agreements on tariffs, trade in goods, services and intellectual property rights.[1528] The WTO aims at

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[1525] Mary Tsai, 'Globalisation and Conditionality: Two Sides of the Sovereignty Coin' (2000) 31 *Law and Policy in International Business*, pp.1317-1318.

[1526] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.199.

[1527] This series of trade negotiations commenced in September 1986 in Punta del Este, Uruguay and concluded in April 1994 in Marrakesh, Morocco.

[1528] The WTO acts mainly by enforcing binding tariff levels, reducing and eliminating quotas on imports, promoting transparent trade policies, and maintaining rules on dumping and subsidies.

ensuring open, fair and undistorted competition achieved by freer trade,[1529] predictable trade policies and fairer competition. These aims are complemented by a commitment to promote the interests of developing countries. At the heart of the WTO system is the original GATT of 1947, which is now part of GATT 1994 (the Marrakesh Agreement) with its dual principles of **non-discrimination**[1530] and **national treatment.**[1531]

Nigeria, South Africa and Kenya are members of the WTO having all joined the organisation on 1 January 1995. Consequently, the disciplines instituted by the WTO over international trade are some of the most formidable legal impediments to the fiscal incentive policies of these three countries. The WTO consists of 12 Multilateral Trade Agreements (MTAs) which country members must accede to.[1532] Of these MTAs, the General Agreement on Trade in Services (GATS)[1533] and Trade-Related Aspects of Intellectual Property Rights (TRIPS)[1534] have limited application to fiscal and other incentive measures.[1535] However, the **Agreement on Subsidies and Countervailing Measures** (hereafter: SCM) and the **Agreement on Trade-Related Investment Measures** (hereafter: TRIMS) have certain provisions constraining the use of fiscal incentives as considered below.

1529 Freer trade connotes liberal trade policies which promote the unrestricted flow of goods and services, sharpen competition, motivate innovation, breed success and reward producers of the best priced products.

1530 Member countries should receive most-favoured-nation treatment and trade policies discriminating against member countries are disallowed.

1531 Once initial bound import tariffs have been paid, imported goods should be treated no less favourably than comparable domestic goods.

1532 AfDB, *African Development Report 2004*, Chapter 5: Africa's External Trade Relations, *op* cit, pp.207-224.

1533 See the GATS Agreement accessed at <http://www.wto.org/english/docs_e/legal_e/26-gats.pdf> on 04.06.07.

1534 See the TRIPS Agreement accessed at <http://www.wto.org/english/docs_e/legal_e/27-trips.pdf> on 04.06.07.

1535 Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.201.

6.3.2.2. The Agreement on Subsidies & Countervailing Measures

6.3.2.2.1. Introduction

SCM was concluded during the Tokyo Round in 1979 and entered into force on January 1, 1995. The SCM initially was quite limited in scope [1536] and application.[1537] UNCTAD notes that these led to few cases on incentives being determined.[1538] Much of these shortcomings were addressed during the Uruguay Round which led to the conclusion of GATT 1994. Of significant importance for developing countries was the concept of a 'single undertaking,' applying the new SCM to all member countries. This however, was moderated by the use of special and differential treatment targeted at developing and least-developed countries. The revised GATT 1994 applies to all WTO member countries, has enhanced dispute resolution mechanisms that are not contingent on the consensus rule and features more robust disciplines on both export related and non-export related FDI incentives. SCM has specific provisions regarding the use of subsidies which have been categorised as specific, prohibited, actionable and non-actionable.

6.3.2.2.2. Specific, Prohibited, Actionable & Non-Actionable Subsidies

Under SCM, **subsidies** are deemed to occur when a government or public body within a WTO member country provides a financial contribution which confers a benefit. Such a financial contribution could be by way of a direct transfer of funds, potential direct transfers of funds or liabilities, the foregoing or non-collection of government revenue that is otherwise due, the provision of public goods or services other than general infrastructure, public funding or establishment of arrangements whereby private bodies are charged with carrying out public functions involving grants, fiscal and financial incentives,

1536 In that SCM's disciplines addressed mainly export subsidies relating to trade.
1537 SCM had limited enforcement procedures, applied only to members who specifically acceded to it, and its dispute resolution mechanism relied on consensuses which were difficult to achieve in practice.
1538 UNCTAD, *Incentives & Foreign Direct Investment*, p.60.

the provision of special infrastructure or indeed, certain forms of income or price support.[1539]

SCM's definition of subsidies is broad enough to include most types of fiscal incentives considered in Chapter 2 of this Thesis. For instance, the grant of tax holidays usually results in revenue forgone and the practice of providing special, subsidised infrastructure on preferential terms under many EPZ regimes may fall within the scope of the provision of public goods and services. Financial incentives such as grants and other direct financial transfers also fall within the ambit of SCM. There is also the concept of **specific subsidies** which are brought under certain disciplines restricting their use by WTO member countries. Specificity, within the meaning of SCM, describes circumstances where a government targets subsidies to certain enterprises, industries or geographical regions within that member state's territory.[1540] Specific subsidies may further classified as prohibited, actionable and non-actionable subsidies.

Prohibited subsidies are subsidies contingent in law or in fact on export performance or on the use of domestic supplies over imported goods.[1541] Such prohibited subsidies include non-agricultural subsidies conditional on export performance requirements and subsidies linked to local content requirements. An Illustrative List of Export Subsidies expatiates on the scope of subsidies prohibited as being contingent on export performance. The List includes the exemption, remission or deferral of both direct and indirect taxes and enumerates the types of subsidies which would be deemed offensive.[1542] UNCTAD notes (in respect of the Illustrative List) that: the exemption or remission of indirect taxes (such as VAT) on exported products or the remission or drawback of import charges on goods not used for the production of exported products, and prior-stage cumulative indirect taxes levied on

1539 Article 1, Subsidies & Countervailing Measures Agreement (hereafter: SCM), accessed at <http://www.wto.org/english/docs_e/legal_e/24-scm.pdf> on 04.06.07.
1540 Article 2, SCM.
1541 Article 3, SCM.
1542 See Annex I: Illustrative List of Export Subsidies, SCM.

(capital) inputs which are consumed in the production of exported products are all permissible under SCM's disciplines, provided that these are not contingent on export performance requirements.[1543]

Actionable subsidies are subsidies which have 'adverse effects'[1544] on another member state's trading interests in that they occasion injury to that country's domestic industry;[1545] nullify or impair WTO benefits that should accrue to that country under GATT 1994;[1546] or otherwise cause 'serious prejudice'[1547] to the interests of another WTO member country[1548].[1549] To reduce the evidentiary burden of establishing allegations of adverse effects, a presumption is raised in respect of certain subsidies which must be displaced by the subsidising country. Finally, **non-actionable** subsidies include all non-specific subsidies and those specific subsidies in respect of: assistance to R&D activities in respect of no more than 75% of the costs of industrial research or 50% of pre-competitive development costs; aid to disadvantaged regions of a member state's territory; and assistance to meet the costs of adapting to new environmental requirements.[1550] However, these subsidies lapsed with effect from 1 January, 2000 due to the lack of consensus on their extension.[1551]

Despite the constraints SCM's disciplines impose on the use of subsidies there are significant opportunities for developing countries (such as Nigeria, South

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1543 UNCTAD, *World Investment Report 2002: Transnational Corporations & Export Competitiveness*, (UN, New York/Geneva: 2002) p.209.
1544 Adverse effects generally connote the distortion of trade flows by subsidised goods either increasing the volume of exports from or imports into the subsidising country member: UNCTAD, *World Investment Report 2002*, *op cit*, p.209.
1545 E.g. by promoting subsidised imports.
1546 E.g. benefits like the improved market access secured by bound tariffs.
1547 Article 6, SCM describes the scope of 'serious prejudice' which includes subsidies: covering operating losses of an industry or enterprise which displace or impede the importation of similar products in the markets of a subsidising or third country or which result in significant price undercutting, price depression or lost sales.
1548 E.g. export displacement of that country's products in the domestic market of the subsidising country or a third country.
1549 Articles 5 & 6, SCM; UNCTAD, *World Investment Report 2002*, *op cit*, p.209.
1550 Article 8, SCM.
1551 Luja *Assessment & Recovery of Tax Incentives in the EC & the WTO*, *op cit*, p.127; WTO 2001 Annual Report, p.63

Africa and Kenya) to benefit from export and local content subsidies due to **special and differential treatment** provided for developing country members. These opportunities are highlighted in the next section.

6.3.2.2.3. Special & Differential Treatment for Developing Countries

In recognition of the important role subsidies play in the economic development of least-developed and developing countries, SCM provides for special and differential treatment for these members states.[1552] Consequently, certain countries in Annex VII of SCM are wholly exempt from the prohibition against export subsidies. Annex VII countries are least-developed country members of WTO designated as LDCs by the UN and certain listed countries until their GNP per capita income reaches US$1,000 for 3 consecutive years as certified by the World Bank.[1553] Annex VII countries had a generous 8-year window within which they must have phased out export subsidies for products in which they have attained export competitiveness[1554].[1555] Crucially, two of the study countries in this Thesis, *viz*. **Nigeria and Kenya**, fall within this latter category and consequently would have enjoyed this special and differential treatment until their economic fortunes improve beyond the specified per capita threshold.

Special and differential treatment for developing country members (such as **South Africa**) which are not listed in Annex VII tends to be less generous. These countries: had 8-years[1556] to phase out their export subsidies; may not increase the levels of subsidies during this transition period under certain standstill provisions; and must phase out over 2-years export subsidies in

<http://www.wto.org/english/res_e/booksp_e/anrep_e/wto_anrep01_e.pdf> accessed 09.10.07.

1552 Article 27, SCM.

1553 Annex VII, SCM.

1554 I.e. until 2002: see Articles 27.4 & 27.5, SCM.

1555 Export competitiveness is defined as an export share of world trade in that particular product in excess of 3.25% sustained for at least 2 consecutive years: Article 27.6, SCM.

1556 Expiring at the end of 2002: UNCTAD, *World Investment Report 2002*, *op cit*, p.211.

respect of products which they have attained export competitiveness.[1557] Finally, as a result of the 2001 WTO Doha Ministerial Conference, certain export subsidy regimes adopted by smaller economies with fragile export markets could be extended to 31 December 2007.[1558] UNCTAD notes that 29 countries have applied for extensions to their export subsidy programmes in relation to EPZ regimes. It is unsurprisingly that **Kenya** features among these 29 countries, given the economic importance of its EPZ garments industry.[1559] The role of EPZs in relation to subsidies regulation remains a controversial issue with opponents and proponents of these measures citing examples of successful and not-so-successful cases where EPZs were utilised. However, given the importance of EPZs in the industrialisation policies of developing countries, it would appear that these measures would continue to be used despite the WTO's concerns regarding destructive subsidisation.[1560]

SCM's disciplines are complemented by the Agreement on Trade-Related Investment Measures (or TRIMs) which provides restrictions on the use of incentives contingent on export performance and local content requirements.

6.3.2.3. The Agreement on Trade-Related Investment Measures

TRIMs elaborates on WTO requirements *vis-à-vis* trade in goods by providing enhanced mechanisms for more effective enforcement.[1561] TRIMs prohibits investment measures inconsistent with the national treatment principle especially the grant of advantages or incentives contingent on local content or export performance requirements. Offending investment measures are to be notified to the Council for Trade in Goods and eliminated over periods of 2-

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[1557] Provided that if such subsidies are justified by that developing country member, they may be phased out over a longer period: Article 27.4.

[1558] Decision of 14 November 2001: WTO Document WT/Min(01)/Dec/17.

[1559] UNCTAD, *World Investment Report 2002*, *op cit*, p.211.

[1560] WTO, World Trade Report 2006: Exploring the links between subsidies, trade and the WTO, pp.xl-xli, 77-82 <http://www.wto.org/English/res_e/booksp_e/anrep_e/world_trade_report06_e.pdf> accessed 09.10.07.

[1561] Article 1, the Agreement on Trade Related Investment Measures (hereafter: TRIMs), accessed at <http://www.wto.org/english/docs_e/legal_e/18-trims.pdf> on 04.06.07.

years for developed country members, 5-years for developing country members and 7-years for least-developed country members.[1562]

An Illustrative List enumerates at length investment measures inconsistent with GATT 1994. In the main, the Illustrative List practices relate to the use of domestic laws or administrative rulings to tie advantages conferred on enterprises to their use of domestic products or their compliance with restrictions on the use of imported products to specified volumes or values of exported goods.[1563]

Easson notes that TRIMs imposes constraints on the use of customs and other indirect taxes to provide protection for domestic industries by offending countries exceeding bound tariff limits agreed during trade negotiations.[1564] Easson also observes that that SCM's disciplines raise issues about the propriety of income tax incentives and reductions tied to export performance, particularly for various EPZ incentives conditional on export performance criteria where '(a) zone enterprises are required to export some part of their production, *and*, (b) the tax privileges that are granted to zone enterprises are not available more generally in the rest of the country.'[1565]

Despite the significant limitations inherent in the SCM and TRIMs Agreements on the use of fiscal incentives, there are notable practical constraints on the ability of WTO disciplines to promptly address adverse effects caused by offending subsidies as examined below.

6.3.2.4. **Practical Constraints on Countervailing Measures**

The WTO permits an aggrieved member country to retaliate against an offending one by imposing countervailing measures where the latter fails to comply with a resolution issued under the dispute resolution procedure.

[1562] Article 5, TRIMs.
[1563] See the Illustrative List: Annex to TRIMs.
[1564] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.202.
[1565] *Ibid*, p.206.

UNCTAD notes that such retaliatory measures are more robust than unilateral countervailing measures in that they are not confined to the territory of the aggrieved party and are therefore more effective measures in contemporary global markets. However, before such countervailing measures are imposed, the aggrieved member country must establish the existence of an adverse effect by demonstrating that there is a causal link between subsidised imports and the injury complained of.[1566]

There are instances of specific domestic tax provisions which would otherwise appear to offend against WTO rules but which, in practice, may not actually violate specific WTO disciplines or indeed, may be of little practical consequence given the opportunities available for firms to achieve identical commercial ends by utilising other, non-offending domestic tax provisions. For example, Easson, referring specifically to **Nigeria**, questions certain practices involving direct tax advantages – namely the grant of 'investment allowances' to firms purchasing locally manufactured plant[1567] and the conferment of 'pioneer' tax holidays to enterprises contingent on their use of domestic raw materials[1568] – as being contrary to GATT/WTO disciplines.[1569]

However, Nigerian tax law does *not* presently provide investment allowances to companies purchasing locally manufactured equipment. Easson's reference to the grant of investment allowances probably relates to provisions of §38(2) CITA 1979 which provide **15% investment tax credits** to companies purchasing locally manufactured plant, machinery or equipment on such fixed assets. In any event, the standard rates of initial capital allowances at 50% for manufacturing, construction and other plant expenditures under the CITA 1979

[1566] Part V, SCM; UNCTAD, *World Investment Report 2002*, *op cit*, p.210.

[1567] Easson cites an article by A. Ajayi as the source of his information on these incentives: see A. Ajayi, 'Nigerian Government Introduces Far-reaching Tax Incentives to Lure Business Investment', Tax Notes International, March 3, 2002 [2002 WTD 114-3].

[1568] This probably refers to §35 CITA 1979 which confers 3-year tax holidays on wholly export-oriented companies conditional, *inter alia*, on their export proceeds constituting at least 75% of turnover.

[1569] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.202.

regime are significantly more generous than the 15% investment tax credit[1570].[1571]

Similarly, under the ID/ITR Act 1971, companies are eligible for up to 5-years of tax holidays which are not necessarily linked to export performance or local content requirements. These provisions are rather wide in theory and are even more flexibly applied in practice. Well-advised Nigerian companies might find the provisions of that Act easier to navigate than those (presumably) referred to by Easson. As such, it is likely that both these provisions queried by Easson may actually be of less practical significance, reducing the actual impact of WTO disciplines.

UNCTAD enumerates further limitations on the efficacy of the SCM regime. SCM disciplines only regulate subsidies on goods, not on services,[1572] and cannot be easily applied to locational incentives. SCM rules are of limited effectiveness as the incidence of 'adverse effects' may occur well after subsidies by way of fiscal or other incentives have been granted. Further, a recommendation to withdraw or modify a subsidy (or the imposition of a countervailing duty due to the failure to give effect to such a withdrawal or modification) may fail to remedy the initial grant of an offending subsidy.

Easson observes that violations of WTO rules tend to continue for extended periods of time prior to resolution, citing as an example the EU-US dispute over the US Foreign Sales Corporations which could be traced to the US DISC regime of 1971.[1573] He further questions the enforceability of WTO rules where disputes arise between developing countries who are fierce competitors for

1570 ¶6 of, and Tables I & II to, Second Schedule, CITA 1979.

1571 As is the **25% investment tax credit** granted to companies that **fabricate** (as opposed to purchase) spare parts, tools and equipment for local consumption and export. However, the local content requirement here is less stringent so it is questionable if this provision actually offends TRIMs: §38(2) CITA 1979.

1572 The General Agreement on Trade in Services (GATS) does not deal specifically with subsidies.

1573 The FSC dispute was only resolved by WTO dispute settlement panel in 1999, some 28 years later: see R.S. Avi-Yonah, 'Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy' (2000) 21 Tax Notes International, 2841.

FDI but have very little common trade with each other. The remedy presented by retaliatory action becomes illusive, undermining the effectiveness of this remedy. In relation to fiscal competition between neighbouring countries to attract FDI to their EPZs, Easson notes that

> … the eventual importing countries have no cause to complain – they did not seek the investment and their consumers benefit from lower prices. The losing bidders may find it difficult to establish that they have suffered any damage as a result of the subsidy but, in any event, they have virtually no trade with the winner and thus are in no position to impose sanctions.[1574]

In these circumstances SCM disciplines may simply be too little too late.[1575]

6.3.2.5. Implications for Local Content & Export Subsidies

Under SCM's disciplines, both local content and export-oriented subsidies are required to be phased out.[1576] Developing countries such as **South Africa** that are not listed in Annex VII to the SCM must review any export subsidy and related incentive programmes by the end of the transition periods. Indeed, even developing country members such as **Nigeria and Kenya** which are listed in Annex VII must consider these issues as future economic prosperity promises to translate them over the US$1,000 GNP per capita threshold. Numerous Nigerian fiscal incentives appear to be presently or potentially inconsistent with WTO rules and which would require immediate rectification or gradual elimination once Nigeria crosses the specified per capital threshold. Similarly, SCM rules on subsidies linked to export performance requirements raise significant questions about the long-term sustainability of Kenya's successful EPZ-based garment industry.

A criticism directed at the SCM regime is that it may affect developing countries which are more likely to use prohibited subsidies linked to export performance and local content requirements. Their better endowed

1574 Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.207.
1575 Part V, SCM; UNCTAD, *World Investment Report 2002*, *op cit*, p.209.
1576 In 2000 for developed countries and 2003 for LDCs: WTO, World Trade Report 2006: Exploring the links between subsidies, trade and the WTO, *op cit*, p.192; Luja *Assessment & Recovery of Tax Incentives in the EC & the WTO*, *op cit*, pp.135-136.

contemporaries are more likely to use non-actionable subsidies including R&D, regional aid and environmental requirements as these subsidies are common in these developed countries.[1577] Middle income developing countries like **South Africa** may find that their efforts to promote R&D activities may fall foul of the WTO disciplines as being too generous.

UNCTAD provides a series of recommendations for developing countries including an evaluation of the respective merits and demerits of the use of incentives to promote FDI possibly as part of an overhaul of the country's tax regime. Other measures include using subsidies as part of an integrated policy package to attract FDI alongside other measures to enhance the level of skills, technology and infrastructure, improve the business environment, and embed FDI into the local economy by fostering linkages. Countries may find that financial subsidies are to be preferred to fiscal incentives as the former are less prone to challenge under countervailing measures. In particular, it may be harder to establish the existence of causal connections between cash grants given upfront and adverse effects. Similarly, while dispute resolution recommendations could require the withdrawal of fiscal subsidies, it is unlikely that SCM's disciplines would require a beneficiary enterprise to repay a cash grant. As SCM aims at eliminating distortions of market access and not the diversion of investment flows, it may be difficult for an aggrieved country member to establish adverse effects as a result of investment incentives diverting FDI away from its territory to that of a competing country member.[1578]

Notwithstanding the foregoing concerns, member countries not benefiting from the Annex VII exemptions could reform their EPZ programmes by removing requirements restricting sales within the domestic market or by establishing new incentive regimes that are not contingent on export performance requirements. Other solutions include the judicious use of border

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1577 UNCTAD, *Incentives & Foreign Direct Investment*, *op cit*, p.62.
1578 UNCTAD, *World Investment Report 2002*, *op cit*, pp.211-213.

tax adjustments, duty drawback and duty exemption schemes, and the reduction or the elimination of import duties.[1579]

6.3.3. Concluding Comments

Multilateral agreements on international trade exert significant constraints on developing countries hoping to utilise tax incentives linked to local content rules and export performance targets. Such international trade obligations influence the selection and content of domestic trade policies of developing countries. Ongoing discussions on the Economic Partnership Agreement (EPA) initiatives have proved challenging. For instance, while South Africa would prefer the EPA to supersede the current Trade, Development & Cooperation Agreement, EU trade officials object to this.[1580]

Developing countries voluntarily accede to WTO disciplines to benefit from the economic opportunities created by freer and fairer trade. Similar, indirect influences have been exerted by multilateral lending agencies on the economic and fiscal policies of many developing and highly-indebted countries which seek to benefit from the credit facilities and advisory services offered by these multilateral lending agencies. The International Monetary Fund and the International Bank for Reconstruction and Development have been at the forefront of tax reform initiatives which influence (and discourage) the use of tax incentives in client countries. Some of these issues are highlighted in the next section (§**6.4**).

1579 *Ibid*, pp.214-219.
1580 OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.493.

6.4. International Financial Institutions, Tax Conditionality & Fiscal Policy Reform

6.4.1. Introduction: The IMF, World Bank & Tax Reform

In addition to the constraints on tax incentive policies imposed by WTO's disciplines are strictures imposed on developing countries which use the credit, surveillance, technical assistance, advisory and other services provided by the International Monetary Fund (hereafter: the IMF) and the International Bank for Reconstruction and Development (hereafter: the World Bank). The World Bank provides and supplements capital, loans, guarantees and other forms of investment to promote development, trade, balance of payment equilibrium and higher living standards in member countries.[1581] The IMF provides credit intermediation, credit-related public goods[1582] and bilateral services[1583] to its member countries.[1584] As regards structural adjustment programmes, Denters observes that the IMF's macroeconomic and 'top-down' approach contrasts with the World Bank's 'bottom-up', microeconomic approach.[1585] While both Bretton Woods' institutions collaborate closely in fiscal reform initiatives, the IMF has had more significant global impact on tax reform by providing technical assistance and tax policy advice to member countries.[1586]

South Africa joined the IMF as an original member on 12 December 1945 while still a British Dominion.[1587] Nigeria and Kenya became members, respectively, on March 30, 1961 and February 3, 1964.[1588] IMF membership is a prerequisite

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[1581] Article I: Articles of Agreement of the IBRD/World Bank.
[1582] By way of oversight of the international monetary system, bilateral and multilateral surveillance, cross-currency statistical information and methodologies, general research and financial sector assessment.
[1583] Including technical assistance, external training and financial assistance to low income countries.
[1584] Final Report of the Committee to Study Sustainable Long-Term Financing of the IMF (the 'Crockett Report'), (Washington D.C., IMF: 2007), p.5.
[1585] Erik Denters *Law and Policy of IMF Conditionality* (Kluwer Law International, The Hague: 1996), p.158.
[1586] Parthasarathi Shome, 'Introduction', in Parthasarathi Shome (ed) *Tax Policy Handbook* (FAD/IMF, Washington D.C.: 1995), pp.19,20.
[1587] Denters *Law and Policy of IMF Conditionality, op cit,* p.36.
[1588] 'Financial Position in the Fund as of April 30, 2007', of Nigeria, South Africa and Kenya respectively, generally available from the IMF website at <http://www.imf.org/external/country/index.htm>.

for membership of the World Bank under the Bank's Articles.[1589] While all three countries are members of the World Bank,[1590] only Kenya belongs to all World Bank Group organisations.[1591] South Africa is not a member of the International Centre for Settlement of Investment Disputes[1592] and Nigeria is not a member of the Multilateral Investment Guarantee Agency[1593].[1594]

This section (§**6.4**) considers the policy constraints imposed by IMF/World Bank tax conditionality and the incidence of tax conditions in the IMF-supported tax reform agendas of Nigeria, South Africa and Kenya. Tax conditionality imposed by the IMF/World Bank completes the triangulation of obstacles that member developing countries must carefully navigate in using fiscal incentives to promote economic development.

6.4.2. **Tax Conditionality & Tax Reform in Nigeria, South Africa & Kenya**

Conditionality associated with IMF credit support is predicated on the need to use adequate safeguards in the deployment of IMF resources made available to members requiring temporary credit support from the Fund.[1595] Compliance with IMF conditionality is critical for countries grappling with adverse economic conditions as IMF approval of such countries' economic policies is not only a prerequisite for World Bank credit but is of enormous influence in securing the confidence of commercial lenders.[1596] As a result, elements of the IMF/World Bank's tax policy reform agenda have increasingly featured in the fiscal policies of developing countries. Such countries frequently find their domestic fiscal policies constrained by varying degrees of tax conditionality.

[1589] Article II, ¶1: Articles of Agreement of the IBRD/World Bank.
[1590] South Africa (1945), Nigeria (1961) and Kenya (1964).
[1591] I.e. International Development Association and International Finance Corporation (1964); International Centre for Settlement of Investment Disputes (1967); and Multilateral Investment Guarantee Agency (1988).
[1592] South Africa belongs to International Finance Corporation (1957); International Development Association (1960); Multilateral Investment Guarantee Agency (1994).
[1593] Nigeria belongs to International Development Association, International Finance Corporation and International Centre for Settlement of Investment Disputes (all in 1961).
[1594] See generally the World Bank's website at <http://www.worldbank.org/>.
[1595] Denters, *Law and Policy of IMF Conditionality*, *op cit*, pp.25-26.
[1596] Such as the London and Paris Clubs: *ibid*, p.51.

Stewart and Jogarajan present a comprehensive critique of IMF-supported tax conditionality and review salient aspects the IMF's tax reforms through its tax conditionality and technical assistance activities.[1597] The authors compare data on tax conditions in an internal IMF review of reform programmes[1598] with their survey of official country policy intentions disclosed by 95 member countries in 490 Letters of Intent[1599] for periods between 1997 and 2004. They link the rising influence of tax conditionality to several factors including: the increasing preoccupation by the IMF's Fiscal Affairs Department (hereafter: FAD)[1600] with the structural and social aspects of fiscal policy in member countries' tax systems: the growth of IMF-sponsored conditional lending on concessional terms since the 1970s; and the considerable reliance by commercial banks on IMF endorsement of macroeconomic policies adopted by member countries.[1601]

Citing Stotsky's review of IMF's tax policy advice in the 1990s,[1602] Stewart and Jogarajan identify the following specific elements in the IMF's standard tax reform package: the early introduction of a broad-based value added tax with a single rate close to 20%; low-rate, investment-neutral corporate and personal income taxes; fewer and simpler import and export tariffs, excise duties,

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1597 Miranda Stewart and Sunita Jogarajan, 'The International Monetary Fund and Tax Reform' [2004] 2 British Tax Review pp.146-175.

1598 Over the decade between 1985 and 1995: see G.T. Abed *et al*, *Fiscal Reforms in Low-Income Countries: Experience under IMF-Supported Programs* (March 1998) IMF Occasional Paper No.160 (IMF, Washington D.C.; 1998).

1599 Denters observes that the letter of intent is prepared by (and therefore remains the responsibility of) the member country. The stabilisation policies it declares do not create legal rights or obligations. This supports the IMF's contention that such policies are those of the country member and not of the Fund, despite the fact that such letters of intent are prepared in close consultation with relevant IMF mission: Denters, *Law and Policy of IMF Conditionality*, *op cit*, pp.87-88;99-100.

1600 Particularly under the leadership of Vito Tanzi as Chief of Tax Policy (1974-1981) and Director (1981-2000) of the FAD.

1601 Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, pp.148-152.

1602 Janet Stotsky, 'Summary of IMF Tax Policy Advice', in Parthasarathi Shome (ed), *Tax Policy Handbook*, *op cit*, pp.279-284.

payroll and land taxes; and tax administration reform.[1603] Stotsky notes that broader, reoccurring themes in the FAD's technical assistance on tax policy include the simplification of existing tax systems to reduce inefficiencies, inequities, high compliance costs and tax evasion, and enhancing revenue generation in the most economically-neutral manner possible.[1604]

IMF-advised tax conditionality features prominently in recent policy documents issued by the Nigerian, Kenyan and South African governments. This trend is unsurprising as all three countries utilise IMF's technical assistance expertise in fiscal policy matters. A cursory perusal of their recent letters of intent, annual reports and other policy documents validates Stewart and Jogarajan's views on the pervasiveness of tax conditionality. In these policy documents, the three governments undertake to implement (or make reference to) fiscal policies broadly consistent with the IMF/World Bank's tax reform advice.

With respect to **Nigeria**, instances of tax conditionality feature in recent policy documents related to the IMF's Policy Support Instrument (or PSI) which under-girds Nigeria's 'home-grown' Poverty Reduction Strategy Paper, NEEDS.[1605] Prior to NEEDS, the Nigeria government aimed at 'broadening the revenue base and strengthening tax administration generally' with an emphasis on improving VAT administration under the Vision 2010 economic plan.[1606] By 2005, the FIRS was being restructured with technical assistance from the IMF's FAD, and the '... tax system reformed in order to broaden the tax base and address distortions, as well as to make the budget less vulnerable to oil price

[1603] Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.152.
[1604] Stotsky, 'Summary of IMF Tax Policy Advice', *op cit*, p.279.
[1605] The IMF notes that PSIs are designed for low income countries that may not need, or want, IMF financial assistance, but still seek IMF's advice, monitoring and endorsement of their policies. Consequently, PSIs are voluntary, demand-driven and based on country-owned poverty reduction strategies involving civil society and development partners as articulated in a Poverty Reduction Strategy Paper: IMF Press Statement #05/229: 'IMF approves a 2-year PSI for Nigeria'.
[1606] ¶21, Nigeria: Letter of Intent and Memorandum on Economic & Financial Policies of Federal Government for 2000, dated July 20, 2000.

shocks'[1607] in line with fiscal policy under NEEDS. In 2006, the Nigerian government promised to continue restructuring FIRS with the introduction of an automated tax administration system and individual tax identification numbers (or TINs). The federal government also undertook to establish a Tax Policy Unit based in the Ministry of Finance by December 2006[1608] and institutionalise tax reforms through the passage of a Tax Reform Bill in the second quarter of 2006.[1609]

Comparable IMF/World Bank influenced tax reforms have been implemented in Kenya and South Africa. In **Kenya**, recent fiscal policies in terms of the ERS correspond to those supported by IMF's FAD technical assistance.[1610] Tax administration reforms in respect of income tax, customs and VAT feature prominently in current fiscal policy.[1611] The significant input of international financial institutions into Kenya's economic, budgeting and fiscal policy has already been noted elsewhere in this Thesis.[1612] Moving South, during the 2006 Article IV consultations, the IMF commended **South Africa** on its declining budget deficit, driven by tax revenues consistently exceeding projections and noted with approval that '...tax policy is generally sound, aiming at reducing tax rates while broadening the base'.[1613]

1607 ¶23, Nigeria: Request for a 2-year Policy Support Instrument – Staff Report; Staff Statement, Press Release on the Executive Board Discussion, & Statement by Executive Director for Nigeria, IMF Country Report 05/432; October 7, 2005, p.11.
1608 Nigeria: Authorities Letter of Intent, Policy Statement, & Technical Memorandum; March 30, 2006, p.9.
1609 *Ibid*, ¶6, p.10. Incidentally, the tax reform legislation was not passed until the second quarter of 2007, a full year later.
1610 Kenya: Republic of Kenya/Ministry of Planning & National Development; 'Annual Progress Report: 2004/05, Investment Programme for the Economic Recovery Strategy for Wealth & Employment Creation 2003-2007'; May 2006.
1611 *ibid*, p.8.
1612 See §**5.1.3** of this Thesis.
1613 South Africa: Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for South Africa; IMF Country Report 06/327; Sept 2006, ¶27, pp.8,15.

There is some ambiguity surrounding this recurring objective of 'broadening the tax base'.[1614] However, in relation to IMF-supported structural adjustment programmes, the concept has been closely associated with the introduction and expansion of broad-based consumption taxes such as the VAT.[1615] The discussion in this section concludes by examining the recent Nigerian VAT rate increase and the implications of this development for the future of Nigerian tax incentives. However, it is useful to first highlight the underlying conflict between efficiency and equity in relation to IMF-supported tax policy reforms.

6.4.3. **Equity vs. Economic Efficiency in Tax Policy Reform**

Stewart and Jogarajan highlight a decline in the importance attached to fiscal equity since the 1980s and link the subordination of tax progressivity to the increasing importance of economic neutrality, economic efficiency and the revenue function in IMF-supported tax policy reform.[1616] As certain IMF staff members have addressed some of the issues raised by the concept of fiscal equity and the frequent trade-off with the often-conflicting concept of efficiency, it may be useful to consider their views here.[1617]

Zee considers the promotion of both efficiency[1618] and equity[1619] as desirable goals, but notes however, that where there is a trade-off between these often competing concepts, the ultimate outcome would depend on the particular

[1614] Stewart and Jogarajan note that this concept has been associated with diverse IMF-supported tax reforms ranging from removal of exemptions and tax incentives, profit declaration requirements, reform of large taxpayer administration to national health levies: Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.156.

[1615] Box 5: 'Why the VAT?' Chapter III: Revenue Policy and Performance in *Fiscal Reforms in Low-Income Countries: Experience under IMF-Supported Programs*, *op cit*, p.22; see also pp.3-4,10.

[1616] Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.164.

[1617] While Tanzi, Zee, Stosky and Shome were IMF economists, the IMF reiterates that their views are the responsibility of these authors and do not necessarily represent those held by the IMF. Nevertheless, it may be fair to say that it is unlikely that the IMF's official position would vary significantly from those expressed by these IMF staff.

[1618] Howell H. Zee, 'Taxation and Efficiency', in Parthasarathi Shome (ed), *Tax Policy Handbook*, *op cit*, pp.25-29.

notion of distributive justice that the policymaker prefers.[1620] Indeed, concepts of vertical and horizontal equity are said to be of 'limited practical value unless and until (a) the basis for measuring equality (and inequality) among individuals is defined; (b) the meaning of equal (and unequal) tax treatment is specified; and (c) implementable tax principles to guide policy are derived.'[1621] Zee recommends the use of social welfare formulae to explicitly describe these elusive concepts.

Zee notes in conclusion that '... the importance of achieving redistributive goals through increasing the progressivity of the income tax system should not be overemphasized, as the efficiency costs of doing so are likely to be extremely high'.[1622] Similarly Tanzi opines that the pressures of globalisation, tax competition, and increasing mobility of capital and labour impose constraints on the ability of governments to give expression to the concept of equity by pursuing progressive taxation and other redistributive policies.[1623] Nevertheless, given the increasing gap between the rich and poor (globally and particularly in developing countries), issues of equity and politics in relation to economic development reoccur frequently in contemporary development policy discussions. The next section highlights the manner in which the World Bank considers the concept of 'equity' and draws parallels with the IMF's approach to these issues.

6.4.4. The World Bank, Tax Conditionality & Equity

A recent World Bank report considers the concept of equity in a development context.[1624] Equity here is conceived as the provision of equal opportunities to

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1619 Howell H. Zee, 'Taxation and Equity', in Parthasarathi Shome (ed), *Tax Policy Handbook*, *op cit*, pp.30-34.

1620 Howell H. Zee, 'Personal Income Tax: Theory of Optimal Income Taxation', in Parthasarathi Shome (ed), *Tax Policy Handbook*, *op cit*, p.119.

1621 Zee, 'Taxation and Efficiency' in *Tax Policy Handbook*, *op cit*, p.30.

1622 Zee, 'Personal Income Tax: Theory of Optimal Income Taxation' in *Tax Policy Handbook*, *op cit*, p.118.

1623 Vito Tanzi, 'Changing Role of the State in the Economy', in *Policies, Institutions and the Dark Side of Economics*, *op cit*, p.27.

1624 World Bank, *World Development Report, 2006: Equity & Development*, (Oxford University Press, New York: 2005).

individuals to pursue lives of their own choosing and to be spared from the ravages of extreme deprivation, irrespective of the conditions of their birth, sex, race, culture and levels of access to health, education and other opportunities.[1625] As regards taxation, the World Bank notes that while fiscal collections are vital to finance equity-enhancing public services, tax evasion or avoidance, and the lack of accountability may result in a break-down of the social compact between governments and taxpayers.[1626] The Bank notes that alternative sources of financing for social services can raise equally severe accountability issues. For instance, countries which depend on 'unearned' natural resource rents may find that while these resources may relieve expenditure constraints, they potentially 'undermine the accountability imbedded in the social compact underpinning sound public finance.'[1627]

However, as regards fiscal policy and tax design, the World Bank's views are consistent with the IMF's economic efficiency-oriented policies as noted above. In relation to tax design, the World Bank enumerates seven key principles necessary to ensure that efficiency costs are minimised without impairing pro-equity outcomes. These principles include: broadening the tax base by the use of a broad-based consumption tax and applying income tax uniformly to all sources of income; reducing tax rates to minimise efficiency costs and economic distortions; avoiding regressive indirect taxes; increasing collections from personal income taxes initially through improved tax compliance but ultimately by equalising personal and corporate income tax rates; implementing property and inheritance taxes as appropriate; and reducing the incidence and impact of hidden, implicit taxes such as bribes, inflation and regulatory charges.[1628]

[1625] *Ibid*, pp.2-3; 18-19.
[1626] *Ibid*, 'Focus 5 on Taxation', pp.176-7.
[1627] *Ibid*, p.176.
[1628] *Ibid*, pp.176-7.

6.4.5. **Equity, Politics and Tax Conditionality**

Stewart and Jogarajan also consider the issue of equity, but from a quite different perspective than that of the World Bank's report. The authors criticise the dearth of attention directed by IMF-induced tax reform to crucial issues of politics and equity. Here, equity exists on several dimensions. 'Internal' or domestic equity refers to the domestic, political bargaining process between the state and a wide spectrum of potential taxpayers, public interest groups and other stakeholders, while 'external' or international equity corresponds to power dynamics underlying the relationships between the IMF and client countries in the international arena.[1629]

As regards internal equity, the authors advocate tax reform '... tied to the specific local politics, taking into account the historical origins of the local state, the inequalities and classes in the society, and other forms of stratification such as ethnic, gender or religious stratification'.[1630] On the issue of external equity, the authors criticise the closed and opaque manner in which tax conditions are negotiated between finance ministry officials and IMF staff, preferring tax reform to be the outcome of open, transparent and inclusive political negotiations between the relevant country member and its internal constituency of taxpayers.[1631]

The authors call for a re-examination of the nexus at which the internal and external dimensions of politics and equity are juxtaposed, arguing that these dual issues are intricately involved in, and consequently, should be explicitly addressed by the processes of tax reform and conditionality.[1632] Citing the example of Ghana, the authors draw connections between the sparse analysis of tax and equity issues in country member policy documents[1633] on the one hand, with the lack of ownership of tax reforms by member country

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[1629] There is also an aspect of fiscal 'equity' associated with progressive taxation.
[1630] Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.166.
[1631] *Ibid*, pp.166-168.
[1632] *Ibid*, p.163.

governments on the other. Ultimately, Stewart and Jogarajan opine that '... the "non-public", secretive and expert-driven process of tax conditionality militates against ownership of tax reform in the national context'[1634] with dire consequences for the sustainability of such IMF-driven fiscal reform.

Stewart and Jogarajan criticise the IMF for rarely addressing issues of politics or equity *vis-à-vis* the process of tax reform and for preferring to perceive this process as '... a matter of economic efficiency and administrative efficacy – of technical or technocratic expertise – rather than as a matter requiring "judgement of social and political priorities".'[1635] The authors argue that unless and until equity and politics are explicitly addressed in the context of public opinion, interest groups and local political factors, developing countries advised by the IMF would fail to achieve 'sustainable tax reform (which) involves a new political bargain that will produce a revenue system that is widely accepted as fair, so that there will be sufficient voluntary compliance'.[1636]

Murunga[1637] makes similar observations regarding Kenya's policy relations with the IMF and World Bank in the 1980s *vis-à-vis* structural adjustment lending. He notes that negotiations on critical matters of economic policy were conducted in secret between the international financial institutions and key a-political, technocrats in the Kenyan government. While this process reduced the risk of opposition from potential dissenters, the success and pace of reforms were dependent on the political fortunes of technocrats favoured by the IMF/World Bank, ironically increasing the risk, uncertainty and unpredictability of the progress of reforms.

1633 Particularly in the brief Letters of Intent and more comprehensive Poverty Reduction Strategy Papers surveyed.
1634 Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.168.
1635 *Ibid*, pp.162-163.
1636 *Ibid*, p.166.

Murunga comments that:

> The question of technocrats raises issues regarding ownership of the reforms. Their dominance in negotiations had serious political implications that donors failed to face. By limiting negotiations to a few technocrats, the donors were in effect depoliticising the reform process and ignoring the wider public, the very constituency that needed to legitimate the reforms. ... the WB/IMF succeeded in having most of their policy decisions passed in parliament with little, if any, debate... This approach contradicted donor rhetoric about participatory development, democracy and good governance. It prevented popular discussion of policies before they were enacted; yet the same people who were denied access to the decision-making process were expected to implement them or bear the cost and consequences of implementation. Reform began to appear more and more as a transaction between technocrats and the donors ... Depoliticising the process simply compounded the problem of ownership of the reform process, prompting one politician to complain that the technocrats alienated the cabinet from the reform process.[1638]

As noted above, the IMF has been very active and influential in promoting the spread of the VAT. However, in certain instances, the manner in which such IMF/World Bank-supported fiscal reforms are implemented has possibly undermined the political legitimacy and broad-based support necessary to guarantee sustainability. Public dissatisfaction often manifests in industrial action as seen in the 1991 2-day strike by 3.5million South African workers protesting against the introduction of a 'regressive' VAT.[1639]

The next section highlights how equity and politics have become particularly relevant in light of the more recent increase of the Nigerian VAT rate. As the VAT increase came about partially as a result of IMF/World Bank and other regional pressures, this development raises the prospect of a possible decline in tax incentives due to compliance with IMF-tax conditionality. This, in turn, raises further issues concerning the sustainability of tax reforms in the absence of a deep sense of ownership forged through negotiations based on both internal equity and external equity.

[1637] Godwin R. Murunga, 'Governance and the Politics of Structural Adjustment in Kenya", in Godwin R. Murunga and Shadrack W. Nasong'o (eds) *Kenya: the Struggle for Democracy* (CODESRIA/Zed Books, London; 2007) pp.272-276.

[1638] *Ibid*, pp.275-6.

6.4.6. Tax Conditionality & Ownership of Nigeria's VAT Rate Reform

The IMF has been extremely influential in the spread of the VAT across developing member countries to replace outmoded turnover and sales taxes. Such sales, turnover, gross receipts or transaction taxes result in tax cascading: incremental taxes levied on various stages of production and distribution result in the inflation of the ultimate price paid by the final consumer. For this reason, IMF staff recommend the replacement of these taxes with a 'good tax' such as the VAT[1640] which avoids tax cascading and associated economic distortions.[1641]

Stewart and Jogarajan note that the IMF's VAT reforms have generally been focused on strengthening VAT administration, removing exemptions, modifying taxation of imports and zero-rated goods, consolidating and increasing the VAT rate.[1642] More specifically, Stotsky indicates that a key aspect of the IMF's tax policy advice has been on encouraging the adoption of consumption-type, single-rate VAT between 10% and 20%, applied to both the manufacturing and retailing sectors, with few exemptions for necessities and essential items.[1643] As seen below, IMF fiscal policy advice on VAT appears to have significantly influenced recent Nigerian VAT reforms.

As early as July 2000, the Nigerian federal government had promised in its undertakings to the IMF to broaden the VAT base over the medium term by increasing the VAT rate from 5% to 10%.[1644] Fiscal policies under NEEDS indicated a preference for a low, stable, simplified tax and tariff regime although NEEDS warned that '... a few new taxes may be imposed and some

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1639 Patrick Bond, *Against Global Apartheid*, (Lansdowne, UCT Press: 2001) pp.xii,68.
1640 Stotsky, 'Summary of IMF Tax Policy Advice' in *Tax Policy Handbook*, *op cit*, p.280.
1641 Howell H. Zee, 'Tax Cascading: Concept and Measurement', in *Tax Policy Handbook*, *op cit*, p.75.
1642 Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.155.
1643 Stotsky, 'Summary of IMF Tax Policy Advice,' *op cit*, p.280.
1644 ¶21, Nigeria: Letter of Intent and Memorandum on Economic & Financial Policies of Federal Government for 2000, dated July 20, 2000.

existing ones increased to raise revenues.' [1645] In particular, Obasanjo's government intended to target indirect taxes such as the VAT and observed that although '... these taxes are generally regressive, the high rate of evasion of direct taxes – attributed mainly to poor data on people and sources of income (the result of the large informal sector) – makes these taxes attractive'. [1646] However, the NEEDS Report, did not specify in greater detail proposals for VAT reform beyond indicating that fiscal reforms would be executed by the legislative means of a Tax Reform Bill.

This Tax Reform Bill comprised various amendments to the main tax statutes. [1647] §4 of the draft VAT Bill proposed the increase of the rate of tax from 5% to 10%. [1648] This proposal generated much controversy when eventually considered by the National Assembly. Despite the best efforts of the Obasanjo administration to persuade the National Assembly, the organised private sector and the Nigerian populace of the need to increase the VAT, there was evidently little local 'ownership' of this particular piece of fiscal policy. [1649] Ultimately, the increased rate was rejected by the Senate and VATA 1993 was amended on 20 February 2007 with the 5% rate remaining unchanged. [1650]

However, in the final days of the Obasanjo administration, the Minister of Finance increased the VAT rate by a ministerial directive to 10% despite the earlier rejection of this proposal by the National Assembly. [1651] The Minister

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[1645] NEEDS Report, Chapter 11: Implementation and Financing, p.115.
[1646] NEEDS Report, Chapter 3: The Macroeconomic Framework, p.21.
[1647] *Viz.*, CITA 1979, PPTA 1969, PITA 1993, ETA 1993 and VATA 1993: see Nine Draft Bills on Tax Reform, Federal Inland Revenue Service Bill 2005, (Abuja FCT, FIRS; 2005).
[1648] §3, Bill for an Act to Amend the Value Added Tax Act 2004 and for Matters Connected Therewith: Nine Draft Bills on Tax Reform, Federal Inland Revenue Service Bill 2005, p.86.
[1649] 'No plans to raise Value Added Tax, say manufacturers', *Nigerian Guardian Newspapers* article, 11th January, 2007 accessed at <http://www.guardiannewsngr.com/news/article04/110107> on 11.06.07].
[1650] §3, A Bill for an Act to Amend the Value Added Tax Act 1993 and for Matters Connected Therewith: Value Added Tax (Amendment) Bill 2007 (Harmonized), (Abuja FCT, The Senate of the FRN; 2007).
[1651] 'Senate faults increase in VAT rate', *Nigerian Guardian Newspapers* article, 24th May, 2007 accessed at <http://www.guardiannewsngr.com/news/article21/240507> on 11.06.07].

purportedly exercised powers under §34(a) VATA 1993 authorising the amendment of the rate of tax by ministerial directive.[1652] The Minister advanced several reasons to justify the VAT increase.[1653] Nigeria's VAT rate, unchanged since VATA 1993 was enacted 14 years ago, was the lowest in the African sub-region and constituted a source of distortion to trade and competition. Nigeria's regional obligations to neighbouring ECOWAS countries required a harmonisation of VAT rates across the region by 2009 under policies agreed by the ECOWAS Commission on Harmonisation of VAT and Excise Duties. A two-year transition period was elected for the VAT rate increases to ensure that regional VAT rates clustered between 10-20% by 2009.

It seems quite a coincidence that this 10-20% band corresponds to that advised by the IMF.[1654] Several ECOWAS countries are currently pursuing IMF/World Bank-advised fiscal policies, many of which inevitably include reforms to increase tax revenues and promote broad-based indirect taxes. Consequently, it would appear that the adoption of IMF/World Bank tax conditionality across the ECOWAS sub-region is likely to be a contributing factor in the recent Nigerian VAT rate increase.[1655]

The VAT increase was not well-received by the majority of Nigerians. The policy was harshly criticised by politicians from the main opposition parties.[1656] The Nigerian Labour Congress commenced an indefinite strike action on 19

[1652] It appears the Minister was mistaken, and intended to rely on §38(a), and *NOT* '§34(a) of VATA 1993 (as amended)'. While §38(a) VATA 1993 vests the Minister with such powers, there is presently no such provision as '§34(a)' in VATA 1993.

[1653] 'Notice of Increase in VAT Rate to 10% and other New Tax Related Regulations' issued by the Office of the Honourable Minister, Federal Ministry of Finance published in Nigerian Guardian Newspapers, Wednesday, May 23, 2007.

[1654] Stotsky, 'Summary of IMF Tax Policy Advice,' *op cit*, p.280.

[1655] This finding is borne out by a perusal by this Researcher of recent PRSP and Letters of Intent available at www.imf.org between the IMF and the larger economies in the 15-state ECOWAS economic block.

[1656] See 'ACF Scribe faults fuel price increase, new VAT rate', *Nigerian Guardian Newspapers* article, 6th June, 2007 accessed at <http://www.guardiannewsngr.com/news/article28/060607> on 11.06.07], and 'Hike in fuel prices, VAT inimical to poverty alleviation programme, says Falae', *Nigerian Guardian Newspapers* article, 6th June, 2007 accessed at <http://www.guardiannewsngr.com/business/article02/060607> on 11.06.07].

June 2007, effectively paralysing public and private sector activities across the entire nation.[1657] President Yar'Adua's sought to appease Labour by meeting key demands including a suspension the VAT rate increase but the strike action continued unabated[1658] till 24 June 2007 when Labour agreed to the concessions earlier offered by the federal government.[1659] Notwithstanding this setback, recent fiscal projections indicate that VAT will become an increasingly more important source of revenues between 2007 and 2010. (*See Figure 6.4 below.*)

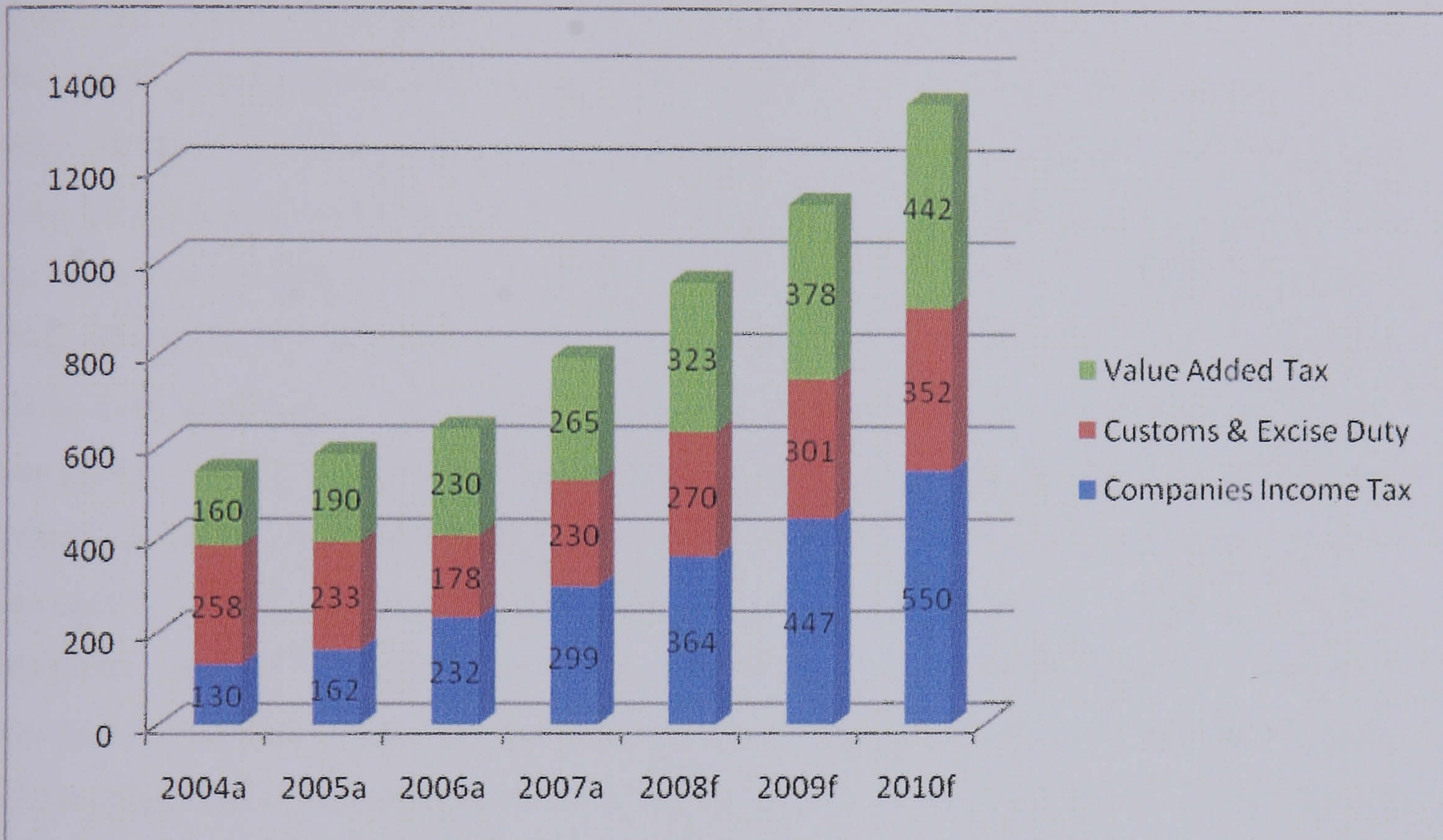

FIGURE 6.4 NIGERIAN NON-OIL TAXES (₦BILLIONS)[1660]

The recent VAT increase is not the only significant IMF/World Bank-supported economic reform to have been rejected by Nigerians. The IMF-

1657 'Strike Paralyses Nigerian cities, businesses', *Nigerian Guardian Newspapers* article, 21st June, 2007 accessed at <http://www.guardiannewsngr.com/news/article02> on 21.06.07].

1658 'FG Reduces Fuel Price, Suspends New VAT Rate', *This Day* newspaper report, 19th June, 2007 accessed at <http://www.thisdayonline.com/nview.php?id=81331> on 19.06.07.

1659 'As FG Promises One Year Ban on Fuel Price Hike, Labour Suspends Strike', *This Day* newspaper report, 24th June, 2007 <http://www.thisdayonline.com/nview.php?id=81833> accessed 25.06.07.

1660 Source: 2008-2010 Medium Term Fiscal Strategy Paper, *op cit*, slide 20.

supported Structural Adjustment Programme (hereafter: SAP) of 1986-1990 remains probably the most controversial economic policy ever undertaken by any Nigerian administration. As seen below, a lack of local ownership of the reforms and the mismanagement of issues of equity and politics contributed to its failure.

6.4.7. **Lessons from Nigeria's Structural Adjustment Program**

The military administration of Gen. Ibrahim Babangida seized power on August 27, 1985 in a palace coup against the regime of Gen. Muhammadu Buhari, who himself overthrew the democratically elected government of Alhaji Shehu Shagari in December 1983. At this time, the Nigerian economy was faring poorly, still reeling from the deteriorating of balance of payments and poor terms of trade precipitated by the oil glut of the late 1970s and early 1980s. Despite the austerity programme, expenditure cuts and tax increases introduced by Shagari and vigorously pursued by Buhari, the Naira remained overvalued, import shortages persisted and the spiralling debt crises defied solution by short-term stabilisation measures.[1661] Shortly after assuming power, Babangida instigated a national debate over the whether Nigeria should undertake an IMF-supported SAP. Despite an overwhelmingly negative response from the Nigerian public in the 1985 referendum,[1662] the Babangida regime nevertheless commenced a comprehensive SAP in June 1996 supported by three (unused) IMF standby arrangements and a US$450million World Bank trade policy and export diversification loan.[1663]

SAP's objectives comprised: restructuring and diversification of the Nigerian productive base to promote non-oil sectors and reduce dependency on oil revenues and imports; restoration of medium-term balance of payments and fiscal equilibrium; promotion of non-inflationary economic growth; and

1661 Gary Moser *et al*, *Nigeria: Experience with Structural Adjustment* (March 1997) IMF Occasional Paper #148, (IMF, Washington D.C.; 1997) pp.7-10.

1662 Adebayo O. Okoshi, 'The Management of Nigeria's External Debt: Issues and Problems' in Adebayo Okosi (ed) *Nigerian External Debt Crisis: Its Management* (Malthouse Press/Nigerian Institute of International Affairs, Lagos; 1990), pp.36-37.

1663 Moser *et al*, *Nigeria: Experience with Structural Adjustment*, *op cit*, pp.7-10.

reducing unproductive investments in the public sector while intensifying the growth potential of the private sector. Key strategies to attain these objectives included: currency devaluation; trade and payments liberalisation; frugal financial and fiscal policies; relaxation of exchange and interest-rate controls in favour of a market-determined system; decontrol of commodity prices and elimination of commodity boards; restructuring public expenditures; privatisation or commercialisation of public enterprises; and removal of subsidies on fuel and agricultural fertilisers.[1664]

SAP's policies provided confidence for debt rescheduling with the Paris and London Club creditors in 1986 and 1989.[1665] While SAP had a positive effect on exports by productive sectors such as agriculture and manufacturing,[1666] runaway inflation was fuelled by an expansion of money supply due to the financing of government deficits by the central bank. The Naira was greatly devalued from US$1:NGN1.538 to US$1:NGN22 between 1986 and 1994,[1667] eroding the savings and incomes of the vast majority of Nigerians. The limited popular support for the SAP further dwindled and ultimately the government withdrew from the programme in 1994.

The jury seems still out on whether SAP was a partial success or an unmitigated failure. Critics of SAP accuse the IMF-supported SAP for the economic re-colonisation of Nigeria;[1668] generating growth without development, creating benefits for the 'rich and strong' while imposing 'the burden of adjustment ... on the weak and poor who are least able to bear it';[1669]

1664 Adedotun O. Phillips, 'A General Overview of SAP' in Adedotun O. Phillips and Eddy C. Ndekwu (eds) *Structural Adjustment Programme in a Developing Economy: the Case of Nigeria* (Nigerian Institute of Social and Economic Research, Ibadan; 1987), p.2.
1665 Moser *et al*, *Nigeria: Experience with Structural Adjustment*, *op cit*, pp.16-17.
1666 *Ibid*, p.27.
1667 *Ibid*, pp.14,43.
1668 John F.E. Ohiorhenuan, 'Re-colonising Nigerian Industry: the First Year of the Structural Adjustment Programme' in Adedotun O. Phillips and Eddy C. Ndekwu (eds) *Structural Adjustment Programme in a Developing Economy: the Case of Nigeria*, *op cit*, pp.133-143.
1669 Bade Onimode, 'IMF and World Bank Programmes in Africa' in Bade Onimade (ed) *Vol. I: the Economic Impact, The IMF, the World Bank and the African Debt*, (Zed Books, London: 1989), p.32; see also pp.26-31.

and imposing pure market solutions designed for developed markets on underdeveloped market economies consequently undermining them.[1670] These views are shared by popular opinion held by the vast majority of Nigerians who associate SAP with the dismal fiscal fortunes, unprecedented currency devaluation and economic decline of Nigeria in the 1980s and 1990s.

Conversely, IMF staff argue in defence of SAP that '(in) terms of results, and despite reversals and setbacks, the analysis shows that the SAP paid off; economic growth accelerated, and the improvement in economic conditions contrasted rather sharply with the pre- and post-adjustment periods' despite '...the inability to bring inflation effectively under control ... (and the) ... attendant substantial depreciation of the naira.'[1671] IMF staff attribute the failure of SAP to: the 'lack of effective coordination of fiscal, monetary, and exchange rate policies (which) undermined the realization of the broader reform agenda and brought the adjustment process to a halt';[1672] the mistake of leaving public finances and other vital sectors of the economy outside the scope of reforms; deteriorating public services and inadequate infrastructure; and, finally, a '... lack of transparency in the management of the country's oil wealth (which) contributed to a distrust in government and prevented a broad-based support for fundamental economic reforms'.[1673]

The resolution of this debate is beyond the scope of this Thesis. It is this Researcher's opinion that, had the implementation of SAP been sustained within a broader matrix of economic and political reforms and (more crucially) executed with the best interests of Nigerians at heart, the IMF's views might have been ultimately validated in practice. Regrettably, history shows that this was clearly not the case. However, the final point advanced by IMF staff

[1670] Bright Okogu, 'Structural Adjustment Policies in African Countries' in Bade Onimade (ed) *Vol. I: the Economic Impact, The IMF, the World Bank and the African Debt, op cit*, p.42.
[1671] Moser *et al*, *Nigeria: Experience with Structural Adjustment*, *op cit*, p.45.
[1672] *Ibid.*
[1673] *Ibid.*

(regarding the lack of transparency and public trust) correlates with the issues of equity and politics examined earlier.

The Babangida government was illegitimate, unelected and increasingly perceived as both corrupt and repressive. SAP had been rejected by the 1985 referendum and lacked local 'ownership'. What little popular support SAP possessed from inception vanished in the wake of the devalued Naira, mounting poverty, social unrest and political discontent. Despite numerous assurances of its commitment to the restoration of democratic rule, the regime ultimately confirmed its critics' fears by failing to hand over to a democratically elected government in 1993 leading to the rise of Gen. Sani Abacha's repressive military dictatorship. In any event, the dearth of local, domestic and popular support exacerbated by the lack of political legitimacy of Babangida's military regime contributed to the reversal of SAP reforms.

It was always unlikely that the VAT dispute and the Nigerian Labour Congress's strike action would result in the demise of the recently elected administration of President Yar'Adua. Happily, political dynamics have changed greatly since Nigeria's return to civilian democratic rule in 1998. However, it is ironic that due to widespread election malpractices committed during the poorly administered Presidential and Parliamentary elections of April 2007, the Yar'Adua administration initially grappled with significant legitimacy issues. It remains to be seen if these challenges can be overcome, and the Yar'Adua administration can not only assume greater legitimacy but continue to successfully engage with Labour, opposition parties and Nigerian taxpayers in a genuine manner to gather support for its economic reforms.

The willingness to suspend the VAT rate increase resulting from negotiations between the government and Labour seems to be a step in the right direction. However, unless Yar'Adua can achieve 'a new political bargain that will produce a revenue system that is widely accepted as fair, so that there will be sufficient voluntary compliance' by ensuring 'widespread political consultation and participation'[1674] and addressing issues of external equity, politics and IMF-tax conditionality in a more open, transparent and public manner than the Obasanjo administration, it is unlikely that fiscal reforms such as the VAT rate increase, no matter how beneficial, can be sustained long enough to yield permanent, positive outcomes. It stands to reason that similar considerations may well apply to the elimination of tax incentives – a policy which is also an intrinsic aspect of the IMF/World Bank-supported fiscal reform agenda.

6.4.8. The IMF/World Bank & the Elimination of Tax Incentives

The IMF consistently opposes fiscal incentives and frequently includes the removal of tax incentives and concessions as a condition for credit assistance.[1675] IMF-supported structural adjustment programmes typically stress the need for fiscal reforms which reduce or eliminate the role of tax incentive schemes, exemptions and deductions to advance the general policy objectives of raising revenues and broadening the tax base.[1676] Specifically, the IMF '... maintains a widely held view that tax incentives of all sorts have proved to be largely ineffective, while causing serious distortions and inequities in corporate taxation' and consequently recommends '...broadening the base of the corporate income tax by eliminating sector- or activity-specific tax incentives' and the uniform treatment of foreign enterprises and both public and privately owned firms.[1677]

The World Bank sets forth a more cautious position, considering that while tax incentives might sometimes affect investment decisions, this is often at the margin and dependant on the particular circumstances.[1678] However, the Bank argues that tax incentives are often not enough to cancel out other more, fundamental disincentives to investment such as poor infrastructure, weak contractual enforcement, rampant corruption and crime. Ultimately, the 'better

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1674 Stewart and Jogarajan, 'The International Monetary Fund and Tax Reform', *op cit*, p.166.
1675 *Ibid*, p.156.
1676 Abed *et al Fiscal Reforms in Low-Income Countries: Experience under IMF-Supported Programs*, *op cit*, pp.10,22.
1677 Stotsky, 'Summary of IMF Tax Policy Advice', *op cit*, p.282.

strategy is to improve the quality of the overall investment climate, thus reducing the pressure to compete on taxes'.[1679]

Chua outlines some criticisms against tax incentives that may broadly correspond to the views of the IMF.[1680] He observes that as there tend to be more compelling reasons informing investment decisions, the merits of tax holidays and other incentives should not be overrated. Tax holidays may not actually benefit unprofitable companies which ideally should be the intended beneficiaries and a policy of rewarding profitable firms for investments that they would otherwise undertake was questionable. Tax holidays had other harmful effects such as eroding the tax base, rendering debt finance less attractive due to lost interest tax shields, promoting short-term investments and providing avenues for tax planning. More generally, tax incentives promote economic inefficiencies, inequitably select certain sectors for preferential treatment, distort relative prices, misallocate resources and undermine tax administration simplicity by escalating monitoring costs.[1681]

Such stringent opposition justifies Easson's observation that for some time, the IMF/World Bank had been waging a not entirely successful campaign to persuade governments to eliminate or reduce special tax incentives.[1682] He attributes the limited success of this campaign to the beliefs of governments in their ability to positively influence market ouctomes or that the elimination of tax incentives would adversely affect the competitive position of such countries *vis-à-vis* their economic rivals in attracting FDI. He notes that efforts to dissuade governments from holding on to these beliefs are often forcefully complemented by the IMF/World Bank imposing strict conditions tying the repeal of tax incentives to the receipt of financial assistance, citing countries

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1678 World Bank, *World Development Report 2005*, pp.168-170.
1679 *Ibid*, p.170.
1680 Dale Chua, 'Tax Incentives', in Parthasarathi Shome (ed), *Tax Policy Handbook*, *op cit*, pp.165-168.
1681 *Ibid*. Other reasons advanced for the elimination of tax incentives have been examined in greater depth elsewhere in this Thesis (see §**2.5.3** above). Consequently, these reasons will not be repeated here.
1682 Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.211.

like Indonesia,[1683] the Philippines, Turkey, Uganda and the Ukraine as examples. However, in all these countries, such reforms have been transient as these governments ultimately capitulate to pressure by investors and other constituencies and revert to tax incentives.[1684]

Tax incentives typically affect a smaller percentage of taxpayers than the broad-based VAT, reducing the prospects for nation-wide industrial action in protest to fiscal policies intent on reducing tax exemptions and preferences. However, it is often the case that powerful, politically-connected and well-advised individuals and entities are able to influence, behind closed doors, the formulation the government policies in more fundamental ways that the public masses can achieve by riots on the streets. Special concessions, preferences and exceptions can be negotiated in favour of select investors, investments and interests. Such concessions are often supported by quite legitimate reasons particularly where subjective, discretionary criteria are applied.

It stands to reason that the equity and political considerations applicable to VAT reform may well apply to the elimination of tax incentives – a policy which is also an intrinsic aspect of the IMF/World Bank-supported fiscal reform agenda. As seen above, this failure of the IMF/World Bank to ensure sustained fiscal reforms in respect of tax incentives can often be directly linked to the overarching issues of internal and external equity raising grave implications for the political legitimacy, ownership and sustainability of fiscal reform.

1683 Note the critique by Wells and Allen of Indonesia's reintroduction of fiscal incentives noted above in **§2.5.3.7** of this Thesis: Wells and Allen 'Tax Holidays to Attract FDI: Lessons from Two Experiments' in Wells *et al Using Tax Incentives to Compete for Foreign Investment Are They Worth the Costs? op cit*, pp.3-67.

1684 Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.212.

6.5. CONCLUSION

International tax, trade and finance arrangements impose certain constraints on the tax incentive policies of developing countries. Interactions between countries' tax codes may result in the wash out or pass through of tax incentive benefits. Regional integration arrangements which involve the ceding of control over sovereign economic and fiscal policies to centralised decision-making bodies within regional economic blocs. Multilateral agreements on international trade constrain developing countries tax incentive policies based on local content rules and export performance targets. While developing country members voluntarily accede to WTO disciplines to benefit from free and fair trade or to the IMF/World Bank's strictures to access credit facilities and policy support, they necessarily surrender a degree of fiscal sovereignty in the process.

However, the dearth of local support and inadequate treatment of equity and political considerations have adversely affected the sustainability of IMF/World Bank supported economic and fiscal reforms. Critics of the IMF/World Bank posit that these efficiency/neutrality initiatives should also address underlying equity and political issues to ensure that the resultant reforms are not only owned by developing member countries but are consequently sustainable. By drawing on Nigeria's past experience with IMF-induced structural adjustment programmes and more current developments with the controversial 100% increase in the Nigerian VAT rate this Chapter has evaluated some implications of tax conditionality for the future of tax incentives in Nigeria's fiscal policy.

An exhaustive consideration of WTO trade restrictions, IMF/World Bank-supported tax conditionality and the constraints these developments pose for tax incentive policies in South Africa and Kenya is beyond the scope of this Thesis. The next Chapter, however, critically reviews the evolution of current Nigerian fiscal policies on tax incentives in context of equity and political considerations, drawing lessons from international experiences as noted in

Chapters 2 and 6 of this Thesis, and more particularly the local experiences of South Africa and Kenya as highlighted in Chapters 4 and 5. This critical examination of Nigeria's tax incentive policies will lead to an exposition of possible lessons from the South African and Kenyan experiences and certain constraints on the applications to the Nigerian fiscal realities.

7. A Critique of Nigerian Tax Incentive Policy with Lessons from South Africa & Kenya

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*"**Ubuntu** is very difficult to render into a Western language. It speaks of the very essence of being human. When we want to give high praise to someone we say, '**Yu, u nobuntu**'; 'Hey, he or she has **ubuntu**'. This means they are generous, hospitable, friendly, caring and compassionate. They share what they have. It also means my humanity is caught up, is inextricably bound up, in theirs. We belong in a bundle of life. We say 'a person is a person through other people'. It is not 'I think therefore I am'. It is rather: 'I am a human because I belong.' I participate, I share."*[1685]

7.0. Introduction

This Chapter traces the recent evolution of Nigeria's tax incentive policy as set out in the Federal Ministry of Finance's Draft National Tax Policy. It criticises specific aspects this Policy and considers certain lessons which could be gleaned from international and regional experiences with a special focus on exemplars derived from South Africa and Kenya. It further notes certain peculiarities of Nigerian tax culture that may influence the applicability of South African and Kenyan exemplars to the practical realities of Nigerian tax incentive policy formulation, implementation and review. This Researcher finds that there are real prospects for a significant improvement in Nigeria's ability to enhance sustainable development through the prudent use of tax incentives.

1685 Nobel Peace Prize Laureate Archbishop Desmond Tutu, *No Future Without Forgiveness*, (Rider & Co, London: 1999), pp.34-35.

7.1. THE EVOLUTION OF CONTEMPORARY NIGERIAN TAX INCENTIVE POLICY

7.1.1. The Study Group & Working Group on Nigerian Tax Reform

7.1.1.1. Introduction

Prior to 2006, there was no comprehensive national tax policy specifying precisely the scope and extent to which tax incentive policy would be utilised in attracting local and foreign capital, promoting growth and otherwise enhancing sustainable economic development. As noted in Chapters 3 and 6 above, fragments of tax incentive policy may be discerned in NEEDS and its underlying Policy Support Instruments. Other references to tax incentives were less by way of clear policy statements and more by way of the enumeration of available tax incentives provided under the Nigerian fiscal regime.[1686] However the status quo changed in 2002.

7.1.1.2. The Report of the 2002 Study Group

On August 6, 2002 a 20-member Study Group was commissioned by the (then) Federal Minister of Finance Mallam Adamu Ciroma to comprehensively review all aspects of the Nigerian tax system and make appropriate recommendations to significantly improve the overall fiscal system. The Study Group was chaired by an eminent economist, Professor Dotun Phillips. Other members were drawn from the federal and state tax authorities and the private sector. The Group's work was divided among sub-committees and its Report was completed in July 2003.[1687]

One of the terms of reference was to 'evaluate and confirm the desirability or otherwise of the retention of the portfolio of fiscal incentives enshrined in the tax laws.' [1688] This issue was considered by the Sub-Committee on Tax Incentives and Disincentives. The Sub-Committee questioned the efficacy of

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[1686] E.g. Federal Ministry of Industry, 'Industrial Policy of Nigeria: Policies, Incentives, Guidelines and Institutional Framework', Chapter 9: Incentives to Industry (Federal Ministry of Industry, Abuja: 2003), pp.44-55.

[1687] Study Group on the Review of the Nigerian Tax System, 'Nigerian Tax Reform in 2003 and Beyond: Main Report of the Study Group on the Nigerian Tax System', (Abuja: July 2003) [hereafter: Study Group's Report].

tax incentives in Nigeria citing a recent IMF study which indicated that these measures ranked low among critical factors for investors.[1689] The Sub-Committee outlined some of the tax incentives available for various economic sectors. The Sub-Committee's work schedule indicated that it intended to examine the costs, benefits and impact of tax incentives using findings from international comparisons and a local survey of beneficiaries conducted by the Nigerian Institute of Social and Economic Research (NISER)[1690].[1691] However, besides confirming the general view of most taxpaying households that the tax structure was harmful to investment, it is unclear whether the survey yielded any specific empirical results on the role and efficacy of tax incentives in Nigeria to aid the Sub-Committee in its deliberations.[1692]

The Sub-Committee recommended that fiscal incentives should be reserved for the oil sector, rural development, solid-minerals development and to promote the development of utilities. Only a few recommendations were made in respect of specific tax incentives.[1693] Curiously, the Sub-Committee was more concerned about 'tax disincentives' to development including: complex, poorly-administered and uncoordinated taxes and incentives,[1694] mismanagement and poor control over public expenditures,[1695]. a lack of transparency and accountability in collection and utilisation of tax revenues,[1696] and multiple

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[1688] *Ibid*, p.2.

[1689] *Ibid*, p.45. This reference is probably to the 2001 study by Wells *et al*: see Wells *et al*, *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs? op cit.*

[1690] Chapter 19 'Survey of Taxpayers, Study Group's Report, *op cit*, pp.324-333.

[1691] 'Subject-matters for Committees', Attachment II to Chapter I, *ibid*, p.24.

[1692] *Ibid*, pp.325. Indeed, a major shortcoming for the entire exercise was the lack of available statistics on taxation (except for Delta, Lagos, Kaduna and Katsina States, and the Customs Service) and the lack of funds for NISER to process more survey data: *ibid*, pp.3-4,333.

[1693] These recommendations included that: (1) the restriction on the absorption of capital allowances to 66 2/3 of assessable profits be removed; (2) unrelieved capital allowances and losses should be carried forward indefinitely instead of expiring after 4 years; (3) taxpayers be allowed to deduct capital allowances and other relief on a self-assessment basis without needing prior approvals from the tax authorities; (4) small companies be required to pay a 2% turnover tax; and (5) the general companies income tax rate be reduced to 20%: *ibid*, pp.62-64.

[1694] *Ibid*, p.56.

[1695] *Ibid*, pp.41,57.

[1696] *Ibid*, p.57.

taxation due to uncoordinated initiatives by the three tiers of government.[1697] The Sub-Committee consequently concluded that the best 'tax incentive' was the judicious management of fiscal revenues on genuine projects that had a direct and tangible bearing on the welfare of taxpayers such as social services, security and human capital development.[1698] Essentially, expenditures focused on enhancing taxpayer morality ranked high on the Sub-Committee's agenda.

Remarkably, the Study Group recommended some controversial policies: all current taxes were to be replaced with just two – an income tax and an expenditure tax; each tier of government – 1 federal, 36 state and 786 local governments – should be free to establish and operate independent tax administrations potentially resulting in over 800 distinct tax agencies; and the capital gains tax should be abolished due to its perceived complexity and inequity only to be reintroduced when the Nigerian economy had sufficiently matured.[1699]

The Study Group concluded that Nigeria's tax system must be reformed to encourage rapid economic growth on a sustainable basis by stimulating savings, investment, job-creation and steadily-increasing per capital income.[1700] A simplified, low-tax regime relying on broad-based taxes was seen as ideal. As incentives made the tax system unduly complex, the Study Group suggested an outright cancellation of all preferential tax provisions replacing these with a low tax rate regime.[1701] A less radical but probably the most important recommendation was that Nigeria adopt, as a matter of urgency, a National Tax Policy which would ensure that exemptions, waivers, tax holidays and tax-free status for individuals and firms would be strictly minimised, streamlined and granted only after due process, with an overall limit on the revenue loss to

1697 *Ibid*, pp.58-59.
1698 *Ibid*, p.60.
1699 *Ibid*, pp.18,27,228-229.
1700 *Ibid*, p.17.
1701 *Ibid*, pp.321-322.

government.[1702] This particular recommendation was further developed by the Working Group which reviewed the Study Group's Report in 2004.

7.1.1.3. The Review by the 2004 Working Group

The policy implications of the Study Group's Report were not comprehensively addressed until a 12-member Working Group was commissioned by the (then) Federal Minister of Finance, Dr. Ngozi Okonjo-Iweala, on January 12, 2004 to critically evaluate the Study Group's recommendations and to propose prioritised strategies to implement the necessary tax reforms. The Working Group's analysis was also divided among sub-committees and its Report was submitted in March 2004. [1703] This Working Group was chaired by Seyi Bickersteth (the Country Partner of KPMG Nigeria) and included the former FIRS' Chairman,[1704] officials from FIRS and the Delta State Board of Inland Revenue,[1705] chartered accountants,[1706] a lawyer[1707] and economists from the World Bank, Lagos Business School and the University of Oxford.[1708] The 12-member Working Group was essentially a private-sector, expert-driven affair and this bias was ultimately borne out in its recommendations which generally favoured investments, savings and private sector interests.

Some of the Study Group's more controversial recommendations were rejected on technical grounds.[1709] The Working Group concurred with the Study Group's recommendation that the restriction on the absorption of capital allowances should be removed. Similarly, the tax incentives regime for petroleum companies (under the 2000 revised Memorandum of Understanding) and

[1702] *Ibid*, pp.26-27.
[1703] Working Group, 'Nigerian Tax Reform 2003 and Beyond: Report of the Working Group on the Review of the Report of the Study Group on the Nigerian Tax Reform', (Abuja: March 2004) [hereafter: Working Group's Report].
[1704] Ballama Manu.
[1705] J.A. Arogundade and Uvioma Akpo.
[1706] Igho Dafinone, Zubairu Abdullahi, G.F. Fasoto and Tunde Ale.
[1707] Dr. Koyinsola Ajayi, SAN.
[1708] Victoria Kwakwa, Pat Utomi and Paul Collier.
[1709] Notably, the Study Group's recommendations on income and expenditure taxes, capital gains tax and independent (overlapping) tax administrations were rejected as being idealistic, impractical and encouragement for tax evasion: Working Group's Report, *op cit*, pp.7-8,16,20.

indigenous marginal field operators were to be discontinued and replaced with a statutory low tax regime with a flat rate of 50%. However, the graduated royalty rates which served as incentives for deepwater onshore and offshore production were to be maintained. The Working Group also recommended that income from gas production and royalties payable by marginal field operators to oil majors should be taxed at the lower CITA rate apparently as a concession to energy multinationals.[1710] The CITA rate itself was to be reduced from 30% to 20% but corporate taxation was to remain a matter of federal competence.[1711]

Other specific recommendations were made in relation to specific provisions of the various taxing statutes.[1712] The Working Group also recognised the need for a National Tax Policy to guide efficient revenue generation, achieve economic diversification and promote sustainable economic development.[1713] The Working Group concluded that tax incentives should be rarely utilised as policy instruments and the best 'tax incentive' was the availability of a low tax regime, good governance, political and economic stability, efficient infrastructure and public services.[1714]

The public-private sector partnership for fiscal policy reform forged through the work of the Study and Working Groups eventually culminated in the formulation of a Draft National Tax Policy by a special committee led by the Federal Minister of Finance.[1715] The Federal Attorney-General led a White Paper/Bill Drafting Committee which finalised proposals for the Nine Draft Bills on Tax Reforms to codify the reforms as legislative amendments to the

1710 *Ibid*, pp.3,12-13.
1711 *Ibid*, pp.4,15.
1712 See the Appendix to the Working Group's Report, *ibid*.
1713 *Ibid*, p.2.
1714 *Ibid*, pp.2,10.
1715 Other members were the Ministers of Agriculture & Water Resources, Commerce & Industry, FCT Abuja, National Planning Commission, Petroleum Matters, and Special Adviser (Export Expansion), C.E.O. NEPC and Chairperson FIRS: Mathias Okwe, 'Draft National Tax Policy wants VAT raised to 15%,' *Nigerian Guardian* (Lagos 10.10.07) <http://www.guardiannewsngr.com/news/article02> accessed 10.10.07.

main tax statutes[1716].[1717] The policy prescriptions for tax incentives indicated in the Draft National Tax Policy are considered in the next section.

7.1.2. **Tax Incentives Under the Draft National Tax Policy**

The Draft National Tax Policy (hereafter: Draft NTP) seeks to provide guidance and a stable reference point for all stakeholders in the Nigerian tax system.[1718] The Ministry of Finance is to coordinate all tax reform initiatives and legislation by cooperating with other stakeholders. While the Draft NTP recognises the legislative supremacy of the National Assembly, it emphasizes the role of the Ministry of Finance in proposing changes in tax legislation.[1719]

The Draft NTP states that the overriding purpose of the Nigerian tax system is to contribute to the well-being of all Nigerians by enabling economic growth and development, providing stable resources to fund prudent public expenditures, ensuring economic stabilisation, horizontal and vertical equity and correcting market failures in appropriate circumstances where taxation is the most efficient device and only in a manner that would minimise the negative effect of taxation on economic efficiency.[1720]

In relation to **tax incentives**, the Draft NTP offers the following policy prescriptions, numbered from (1) to (5) for ease of reference: (1) existing incentives would only be extended to favoured economic sectors where there are overwhelming reasons to do so and this would result in tangible benefits to the overall economy (and not just that favoured sector);[1721] (2) the Nigerian tax system would minimise and steam-line the number of tax incentives to restrict their use to instances where they help to achieve a national objective that

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[1716] 'Current Tax Policy Reforms', FIRS webpage <www.firs.gov.ng/about_us/mission_and_mandate/index.html> accessed on 06.09.2007.

[1717] Federal Government of Nigeria; Federal Inland Revenue Service: Nine Draft Bills on Tax Reform, Federal Inland Revenue Service Bill (Abuja FCT: 2005).

[1718] Federal Government of Nigeria; Draft Document on National Tax Policy: Presentation by the Presidential Committee on Tax Policy (Abuja FCT: 2007).

[1719] Draft NTP, pp.2,9-12,17.

[1720] *Ibid*, pp.3-5.

[1721] *Ibid*, p.6.

cannot be achieved more efficiently in any other way;[1722] (3) certain tax incentives that were difficult to implement and monitor would be deleted or simplified;[1723] (4) investment tax credits should be provided to encourage investment in long-lived capital goods in all economic sectors; and (5) pioneer tax holidays should be targeted at private sector investments in providing public goods such as infrastructure, basic services (power, transportation, education, health) and in other key sectors (gas, exports and agriculture).[1724]

This Researcher obtained valuable information on the formulation of the tax incentive aspects of the Draft NTP during the Nigerian Field Trips particularly from discussions with **Mike Hugman**, Technical Assistant to Olabode Agusto, (then) the Director-General and Special Adviser to the President on the Budget.[1725] Hugman explained that the Budget Office was conducting an on-going review of the National Tax Policy in conjunction with the Ministry of Finance and FIRS. The overarching strategy of the Budget Office and Ministry of Finance *vis-à-vis* fiscal policy was to simplify the complexity of the Nigerian tax system and replace the existing high effective tax rate with a regime of low effective tax rates, simple structures and a broad tax base.[1726] Sustaining employment and productive capacity in the economy were considered to be more important fiscal policy objectives than simply increasing public revenues.[1727] Therefore, a specific policy thrust to achieve these ends was to

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[1722] *Ibid*, p.22.

[1723] The following incentives were to be withdrawn: small companies' relief; the capitalisation of R&D expenditures (to be expensed instead); investment tax credits on locally made spare parts; tax holidays for agricultural and solid-mineral development companies; and relief for reinvestment in tourism facilities: *Appendix Three: Appraisal of Existing Tax Incentives*, Draft NTP, *op cit*, pp.46-54.

[1724] *Appendix Two: Strategy for Implementation of the Proposed Policy*, Draft NTP, *ibid*, pp.38-40.

[1725] Teleconference/Interview with Mike Hugman, Technical Assistant to the Director-General/Special Adviser on Budget, Budget Office of the Federation, Federal Ministry of Finance (Abuja FCT, Mon 5 February 2007).

[1726] Tax compliance was to be improved by increasing the awareness of tax morality especially for higher income earners who had a greater incentive to evade, improving tax collection mechanisms and reducing tax loopholes.

[1727] Olabode M. Agusto, Director-General, Budget Office of the Federation; Presentation on 'The Role of Tax Policy in Driving Economic Growth and Development in Nigeria' delivered at Retreat organised by the Joint Tax Board (August 22-24, 2005; Abuja), slides 10-15.

extend the scope of tax incentives to target investment in key infrastructural sectors and promote sustainable economic development.[1728]

Other efforts were being made to redesign the Nigerian tax system to compete internationally against certain benchmark countries namely **South Africa**, Ghana and **Kenya**. The IMF had been consulted on this project and had provided considerable input. The IMF (as usual) disapproved of tax incentives due to unfavourable results in other jurisdictions and recommended the generic policy prescription of lower tax rates, broader taxes and fewer tax incentives. Nigeria concurred with the IMF's advice and desired to utilise VAT as the principal non-oil tax given its incidence on expenditure and relative ease of collection.[1729]

Despite the IMF's reservations, the Budget Office believed that tax incentives could still play a role in fiscal reform. However, the Budget Office was not naïvely expecting tax policy alone to attract or repel investment, but sought to utilise fiscal measures as tools to encourage vital investment in essential infrastructure. For instance, tax holidays were to be targeted precisely to promote investment in electric power supply, gas projects, export-oriented markets, transportation, agriculture, education and healthcare. Specific, time-bound incentives were to be provided to remove infrastructural disincentives to local and foreign investment making Nigeria more attractive for productive sector industrial activity and diversifying the industrial base. Private investors would be also allowed to charge user-fees to accelerate key investments. Simple strategies were to be implemented through-out to achieve these ends as experience had demonstrated that complex economic strategies were seldom successfully implemented in Nigeria.[1730]

1728 However, Mike Hugman observed there were significant challenges particularly with forming tax incentive policy in a statistical vacuum as reliable fiscal data was extremely difficult to generate.

1729 Budget Office of the Federation; Presentation on 'IMF Comments on FGN Tax Strategy: FGN Strategy and Position on Issues Raised' (January 24, 2007; Abuja), slides 5,8,10.

Unfortunately, the adoption of a Draft NTP was not consummated under the Obasanjo administration and it fell to President Yar'Adua's government to complete the process. The underlying political dynamics have changed significantly with the change in administration. Key members of the previous Presidential Economic Team who played active roles in generating the Draft Policy are no longer relevant;[1731] new officials have risen to the fore. However, several key officials involved in recent economic and fiscal policy remain in the same or similar positions of authority.[1732]

The new Presidential Economic Team has indicated its commitment to build on past successes and adapt existing economic policies to present realities. It is probably the case that much of the fiscal and economic policy content will remain the same as that under the Obasanjo regime but with a different approach to implementation, given the greater emphasis placed by Yar'Adua's administration on the rule of law and due process. This may result in slower progress in implementing reforms but paradoxically may lead to more sustainable results and less erratic policy reversals. Only time will tell.

The next section criticises specific aspects of the Draft NTP with a view to highlight certain shortcomings which, if remedied, would improve the prospects that Nigerian tax incentive policy may enhance sustainable economic development.

1730 *Ibid*, slides 3,8.

1731 Notably, the former Director-General, Budget Office (Olabode Agusto), the Federal Ministers of Finance (Dr. Ngozi Okonjo-Iweala and Nnenadi Usman) and the Minister of the FCT (Nasir El-Rufai) are no longer senior government officials.

1732 Ifueko Omoigui and Professor Charles Soludo retain their positions (respectively) as the FIRS Chairperson and the CBN Governor. Soludo's deputy, Dr. Usman Shamsuddeen, is now the Federal Minister of Finance and replaces Soludo as the Chairman of the new Presidential Economic Management Team (Omoigui is also a member of the Team). Dr. Bright Okogu (former special assistant to the Minister of Finance) has replaced Agusto as the Director-General, Budget Office. Nasir El-Rufai has been appointed as a member of the new National Energy Council. Yar'Adua's administration is implementing economic policies under NEEDS, Vision 2020 and the 7-Point Agenda.

7.2. A CRITIQUE OF ASPECTS OF NIGERIAN TAX INCENTIVE POLICY

7.2.1. Introduction

The Draft NTP is a commendable effort by the Nigerian government to set out key principles and concepts that would guide policy in respect of tax incentives and other important fiscal issues. There is a clear consistency in fiscal policies designed to achieve certain objectives by the prudent but limited use of tax incentives. This theme runs through various policy documents ranging letters of intent, [1733] poverty reduction strategy papers (i.e. NEEDS), national industrial policies and ultimately to the Draft NTP.

The government supports fiscal policies that would complement and not hinder efforts to promote strong and competitive firms, increase national employment and enhance industrial productivity. The provision of essential infrastructure and adequate security would foster a stable and progressive investment environment. The proponents of the Draft NTP consider that a regime of low and competitive taxes, with targeted tax incentives for key sectors, is a vital aspect of this strategy. Prudent fiscal policy is deemed to be a useful tool to generate sufficient resources to finance and maintain infrastructure, secure life and property and ensure that investors find the Nigerian corporate tax environment more attractive than any other country in Sub-Saharan Africa.[1734]

The Draft NTP reflects these policy priorities in stating that: '(the) Nigerian tax system will minimise and steam-line the number of tax incentives and restrict their use to instances where they help achieve a national objective that cannot be achieved more efficiently in any other way.'[1735] For instance the Draft NTP recommends the withdrawal of tax holidays from cement producers

[1733] In 2000, review of energy sector tax incentives indicated that while the Memorandum of Understanding incentives were broadly appropriate, there was scope to target incentives by restricting the ability of petroleum companies to offset gas and power projects' expenditure from tax liabilities: ¶19, Nigeria: Letter of Intent and Memorandum on Economic & Financial Policies of Federal Government for 2000, dated July 20, 2000.

[1734] Olabode M. Agusto, Director-General, Budget Office of the Federation; Presentation on 'The Role of Tax Policy in Driving Economic Growth and Development in Nigeria', *op cit*, slides 10-17.

[1735] Draft NTP, p.22.

considering that there are more direct (and less distorting) means of addressing the national shortage in cement supplies.[1736] However, there are certain shortcomings evident in the Draft NTP that may impede the very development objectives sought to be attained.

7.2.2. Constitutional Competence & Expertise for Tax Policy Formulation & Legislation

The Draft NTP refers to the National Assembly as the guardian of Nigeria's national tax policy[1737] apparently recognising the Legislature's exclusive role in enacting statutes for the federation and the states. However, the Ministry of Finance considers itself to be directly responsible for the formulation of fiscal policy and tax legislation reform. The Draft NTP pointedly states:

> The Ministry of Finance should be the body charged with providing the oversight function over the activities of the tax and Revenue Authorities in Nigeria, as well as being the sole organisation responsible for tax policy matters including drafting any amendments to laws or legislations on taxation ... no Government Ministry or organisation or persons will have the laxity to propose legislation for drafting on tax and revenue, except such that is routed through the Federal Ministry of Finance ... the Ministry of Finance shall have the sole responsibility to propose to the Legislature any amendment or addition to existing and new Tax Legislation. This centralisation of the system for proposing tax policy by the Ministry of Finance will enable sustained co-ordination in the number and thrust of tax legislations being passed to the legislature for ratification...The Constitution of the Federal Republic of Nigeria vests the powers to make laws on the legislative arm of the government comprised of by the National Assembly and the respective State Houses of Assembly. It is therefore the constitutional responsibility of these 'Houses' to make tax laws or amend existing laws, after obtaining the recommendations from the Federal Ministry of Finance.[1738]

Certain provisions of the main tax statutes support this position. The Federal Minister for Finance has traditionally exercised powers to amend certain provisions and schedules of tax statutes.[1739] The President may also delegate responsibility for any business of the federal government to other

[1736] *Appendix Three: Appraisal of Existing Tax Incentives*, Draft NTP, *op cit*, p.47.
[1737] Draft NTP, p.2.
[1738] *Ibid*, pp.9,11,12.
[1739] See §§2 & 63, PPTA 1959; §§5 & 105, CITA 1979; §38 VATA 1993.

functionaries such as the Minister of Finance.[1740] However, this power to delegate extends only as far as the act concerned is within the competence of the executive arm of the federal government.[1741] There are instances where the executive has been accused of usurping legislative powers and not fully complying with obligations imposed by due process and the rule of law.[1742] The legislative and judicial powers of the other arms of government impose necessary checks on the competence of the executive to propose and implement policies through legislation or regulations. Federal legislative competence to enact statutes on matters on the Executive and Concurrent Legislative Lists remains with the National Assembly.[1743] Consequently, the Draft NTP cannot derogate from constitutional provisions regarding the proposal and enactment of legislation by the National and State Legislature.

An issue ancillary is ensuring continuity in the Finance Ministry's tax policy expertise. The competence and expertise of Ministry officials, functionaries and staff has been enhanced over the years by local training and development programmes and by international technical assistance from international financial institutions (hereafter: IFIs) such as the World Bank and the IMF's FAD. The Federal Ministry of Finance has benefited from international initiatives including the establishment of a Tax Policy Unit (designated as the Fiscal Department) based in the Ministry of Finance in December 2006.[1744]

[1740] §148 CFRN 1999; §100 CITA 1979.
[1741] §5(1)-(2) CFRN 1999.
[1742] Case in point were allegations by the Senate that the Obasanjo administration approved the *Minerals and Mining Bill 2006* before the Senate had formally sent a copy of the Bill to the executive for the presidential assent: Sufuyan Ojeifo and Onyebuchi Ezigbo, 'New Mining Act: Senate Rejects Presidential Assent' *This Day* (Lagos 07.02.07) <http://www.thisdayonline.com/nview.php?id=69955> accessed 11.09.07.
[1743] §4(1)-(5) CFRN 1999.
[1744] Nigeria: Third Review under the PSI, Appendix I: Authorities Letter of Intent; May 28, 2007, p.38.

This Researcher was opportune to interview two recently appointed officials of this **Fiscal Department.**[1745] Both officials acknowledged the tremendous task ahead of the Fiscal Department in advising the Finance Minister on fiscal affairs, collating statistics and coordinating fiscal activities with other relevant agencies such as FIRS, the Customs Service and the National Planning Commission. However, the Department had only been recently constituted; much of the policy work had relied substantially on the expertise of external consultants. While it was acknowledged that the Department was responsible for fiscal research and policy development, many responsibilities roles were likely to be outsourced by commissioning external experts and consultants.

The Fiscal Department was still in an embryonic, formative stage at the time the officials were interviewed. There were specific, sequential plans to upgrade the capacity of the Fiscal Department to ensure that it was well equipped to discharge its functions. Significant progress has been made in this regard since February 2007. However, it does give one cause for concern that such an important task – that of federal fiscal policy formation – was delegated to a new department that had not been fully empowered to discharge its weighty duties. The use of external experts and consultants remedies some of these shortcomings. However, there were other indications that there was a degree of resentment in some quarters of the federal civil service towards a proliferation of external experts and consultants. Some of this resentment may be legitimately disregarded as being simply misplaced. However, to the extent that this practice impedes capacity building in government ministries, departments and agencies, the use of external experts and consultants could be counterproductive.[1746]

[1745] Interview with Mrs. M.O. Olowu: Director (Fiscal) and Mr. Tor Tsavsar: Assistant Director (Fiscal), Fiscal Department, Budget Office of the Federation, Federal Ministry of Finance (Abuja FCT, Tue 6 February 2007).

[1746] Interview with Mr. Fidel Oday, Chief Administrative Officer, Multilateral Relationships Department, Federal Ministry of Finance (Abuja FCT, Fri 2 February 2007); Interview with Ms. Rita Maselia, Official, Federal Ministry of Finance (Abuja FCT, Sat 3 February 2007).

In this Researcher's opinion, it is incumbent on the federal government to staff its ministries, departments and agencies with the best talent available and to adequately train, resource and otherwise empower such staff to achieve their stated objectives. Insofar as the necessary human and material resources are not allocated to these functions it is unlikely that the relevant ministries, departments and agencies will be able to deliver the quality and scope of results required to promote sustainable economic development. Where talent and resources exist within other ministries, departments and agencies, such talent could be formally or informally co-opted or coordinated to ensure that human and material resources are efficiently and effectively utilised. In this regard, there may be scope for greater collaboration between the Ministry of Finance's Fiscal Department and FIRS' Tax Policy Research and Development Department. Similar collaborations could also be forged with the relevant statistical and research departments of the Nigerian Customs Service, National Planning Commission and CBN.

7.2.3. **Criticism of Particular Tax Incentive Policies**

The last section set out concerns regarding the constitutional competence of the Federal Ministry of Finance in legislative affairs and the expertise of the Ministry's Fiscal Department. Beyond these criticisms are other concerns regarding particular policy statements in the Draft NTP. As the formulation of the Draft NTP appears to be a closed process, there may well be certain procedures involved in policy-making that may have been less obscure had more information been available. [1747] Notwithstanding this opacity, this Researcher submits the following observations.

It has been noted that the Draft NTP prescribes that (1) incentives should be extended to only those sectors which yield positive externalities for the overall

[1747] This Researcher encountered a marked reluctance by civil servants to venture personal views or opinions that may illuminate actual policy decisions taken by Ministers. There seems to be an unwritten rule that civil servants should be rarely seen and never heard in public: Focus Group Discussion with Richard Ough and other members of the FIRS Tax Policy Research & Development Department, FIRS Headquarters (Abuja FCT, Weds 31 January 2007).

economy.[1748] This begs the question as to how the impact of such positive externalities on economic development would be measured. Will parameters include the quantum of investment, numbers of employees, duration of economic activity or indeed, relative significance of the particular economic sector? How will borderline cases be resolved? Further, would measurement be conducted *ex ante* (based on proposals or projections), *ex post* (based on actual, achieved results) or a combination of both to determine the variance, and extend or withdraw incentives as appropriate? At first glance, it appears that discretionary approvals would be best suited to target incentives to desirable investment. However, such discretionary systems create avenues for rent-seeking and official corruption, and may divert scarce public resources from revenue-generation to investment promotion.

Certain tax incentives are to be deleted or simplified under the Draft NTP including (3) small companies' relief, capitalisation of R&D expenses, investment tax credits for locally manufactured spare parts, tax holidays and reinvestment relief for tourism facilities. This restriction on incentives is to be relaxed only where national objectives cannot be achieved more efficiently in any other way (2).[1749] However, would political expediency qualify as a valid justification for the retention of an incentive? For instance, it may be more politically expedient to give SMEs tax incentives as opposed to cash grants, though latter may be less distorting and more valuable incentives. The Nigerian Constitution has certain provisions regarding the allocation of federal resources to the various tiers and arms of government that disallow extra-budgetary allocations and could conceivably impede the award of grants to deserving micro-enterprises.[1750] The best option of course would be to amend constitutional provisions restricting the purposes for which federal funds may be applied. However, given the realities of Nigerian politics, achieving such constitutional amendments may prove to be exceedingly difficult.

[1748] Draft NTP, p.6.
[1749] *Ibid*, pp.22.
[1750] §§80-83, CFRN 1999.

Expensing R&D expenditures (instead of capitalising them) seems consistent with WTO obligations and economic policies under NEEDS. However, in general, accumulated tax losses may only be carried forward for 4 years. Consequently, the absence of indefinite tax carry-forward periods in sectors other than energy and agriculture may render the incentive benefits of expensing R&D outlays illusory.

It is unclear if tax holidays are to be continued for agriculture.[1751] The rationale for withdrawing tax holidays from solid minerals development seems similarly obscure, particularly in view of the proliferation of tax holidays in all economic sectors except financial services.[1752] Investment tax credits and capital allowances may prove to be less costly and more effective in this regard. It may be the case that a combination of fiscal, financial and other incentives is necessary to attract sustainable investment away from the dominant energy sector and into the agriculture, mining and tourism sectors. It appears presumptive of the Draft NTP to rule out the use of tax incentives for these sectors in the absence of studies on the feasibility of integrated development plans coordinating initiatives by the Ministries of Solid Mineral Development, Tourism and Finance. Conversely, it may be the case that no incentives are needed other than the availability of affordable finance, basic infrastructure, essential services and adequate security.

The Draft NTP does not indicate if any studies have been conducted to rule out (or rule in) these alternatives. Indeed, it appears from some of the policy statements that more background research may have been useful in informing proposed policies. The Draft NTP suggests that pioneer tax holidays should be **extended to 7-years** for EPZ firms. However, under existing laws EPZ firms are entitled to **indefinite** tax holidays. Also, the Draft NTP seeks to preclude

1751 Budget Office of the Federation; Presentation on 'IMF Comments on FGN Tax Strategy: FGN Strategy and Position on Issues Raised' (January 24, 2007; Abuja), slide 3 cf. Draft NTP, p.48.

1752 The Draft NTP justifies the withdrawal of tax holidays with the observation that mining companies do not seem to exploit these measures but no analysis is made as the possibility of EPZ firms exporting any quantity of goods into the Nigerian customs territory.[1753] Many jurisdictions permit the export of a small percentage of goods into their customs territories from EPZs, subject to certain restrictions.[1754] Given the notoriously porous nature of Nigeria's national borders, it may be prudent to allow the export of a certain percentage of goods rather than providing additional incentives for smuggling.

The formulation of the Draft NTP is a useful and essential activity that seeks for the first time to coordinate Nigerian fiscal policy around a set of key concepts and principles. However, in this Researcher's opinion, there are certain aspects regarding tax incentive policy which are not the product of rigorous research or analysis and could be better conceived. There is a clear need for more empirical work on reliable statistics to inform policy decisions. It is regrettable that at present the capacity to conduct such studies and generate vital information from available data appears to be lacking as this will inevitably undermine the quality of any efforts at policy design, implementation and review.

The foregoing discourse has considered specific criticism of certain aspects of the Draft NTP's tax incentive policy prescriptions. The next section considers other issues which could have been addressed in the Draft NTP but were, for whatever reason, excluded. These issues include those previously developed above in Chapter 6.

7.2.4. Limited Regional & International Influences on the Draft NTP

Chapter 6 of this Thesis has demonstrated that certain regional and international influences constrain the tax incentive policies of developing nations, particularly those in Sub-Saharan Africa. Despite the fact that numerous studies corroborate this view, there is precious little direct reference

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to why this is so (*ibid*, p.49). As indicated in §**3.2.7** above, it has only been in recent years that the government has encouraged investment in mining.

[1753] Draft NTP, p.40.

[1754] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, pp.185-186.

in the Draft NTP [1755] to the important interactions between domestic tax incentive policy and the realities of international tax law, regional integration arrangements, global trade regulations and tax conditionality imposed by IFIs.

The only direct reference to international issues is where the Draft NTP indicates the government's commitment to expand the network of international tax treaties to reduce double taxation; realise a common VAT, tariff, trade and competition policy for ECOWAS; and provide adequate international training for middle and top level revenue officials to ensure the maintenance of global best practices. [1756] Besides these matters, the Draft NTP seems to maintain a strictly national perspective and overlooks significant international influences on and interactions with domestic fiscal policy. In this Researcher's opinion, these matters merit consideration and possible inclusion in the Draft NTP.

Viherkenttä's study indicates that countries would do well to examine the tax provisions of their most important treaty partners when formulating tax incentive policy to minimise the scope for the wash-out of tax incentive benefits. It does not presently appear that this idea or any relevant experiences from Nigerian tax treaty negotiating teams are reflected in the Draft NTP. The Draft NTP does not specifically examine the harmonisation of tariffs and tax incentives across the ECOWAS bloc to promote regional fiscal cooperation even though Nigeria's CET regime has been cited as an impediment to regional tariff convergence. [1757] Similarly, the Draft NTP appears to completely ignore trade issues concerning the use of tariffs and subsidies contingent on exports and local content.

Consideration of these international influences is critical particularly where Nigeria's fiscal policies are perceived by international investors and their tax

[1755] Or indeed in the previous Reports of the Study Group and Working Group.

[1756] Draft NTP, p.15.

[1757] However, one of the reasons why the Working Group saw the Study Group's recommendation for dual direct and indirect taxes as idealist and impractical was that the proposal's implementation would conflict with Nigeria's tariff policy advisers to discourage investment. Discussions with **Michael Honiball** (Director of International Tax, KPMG South Africa) indicate that many of KPMG's Southern African clients had a negative perception of the Nigerian revenue authorities' attitude to granting treaty benefits and otherwise applying tax laws in a consistent manner to promote inward FDI. He noted that having a regional pan-African body of tax experts in similar fashion to the regional SADC arrangements could go a long way to promoting consistent tariff, tax incentive and other fiscal policies that would encourage private investment within Sub-Saharan Africa. In his opinion, this arrangement would be useful in harmonising of tax rates and fiscal incentives to combat tax competition as well as permitting poorer Sub-Saharan African countries greater latitude with tax incentives.[1758]

Given the significance of South Africa to regional trade (and particularly, trade with Nigeria) these concerns should not be ignored as immaterial. In this Researcher's opinion, a comprehensive study of the manner in which these issues – international tax law, regional integration arrangements, global trade regulations and IFI tax conditionality – affect or interact with Nigerian fiscal and tax incentive policy would have been immensely useful in formulating the Draft NTP. A cursory enquiry into the tax practices of Nigeria's top ten trading partners might reveal other important issues that could well affect the design, implementation and review of the Draft NTP.

Lessons could be learned from benchmarking Nigerian fiscal incentive policies against those of similar developing countries within and outside Sub-Saharan Africa. This Thesis does not purport to be such a comprehensive study; its aims and objectives are limited. However, the next section suggests a few lessons that could conceivably be learned from the South African and Kenyan experiences.

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obligations under ECOWAS and other bilateral or multilateral agreements: Working Group's Report, *op cit*, p.20.

1758 Interview with Michael Honiball: Tax Partner and Director (International Tax), KPMG Services (Proprietary) Ltd, KPMG RSA National Office (Johannesburg, Thurs 24 May 2007).

7.3. SPECIFIC LESSONS FROM SOUTH AFRICA & KENYA

7.3.1. Caveat

Chapters 4 and 5 of this Thesis respectively review the tax incentive policies and provisions operative in South Africa and Kenya. As indicated in Chapter 1, much of this research was conducted using bibliographical methodology. This method was complemented by interviews and teleconferences. While the South African enquiries were entirely successfully, some difficulty was encountered in obtaining data, information and perspectives on tax incentives in Kenya. However, these difficulties were largely resolved and in the opinion of this Researcher, do not materially impair the comparisons made with Nigeria.

7.3.2. Lessons from South Africa

7.3.2.0. Introduction

Nigerian tax incentives, particularly for the petroleum sector, tend to be more complicated than equivalent South African measures given the fact that the Nigerian tax system is comparatively less sophisticated than the South African tax system. The role of tax incentives in South Africa is rapidly evolving as discussed in greater detail in Chapter 4. There is much greater sophistication in the design and variety of incentives utilised though some of these are being phased out in lieu of subsidies. The following lessons may be gleaned from the South African experience.

7.3.2.1. Targeting Incentives

Targeting incentives is an important process that involves identifying the specific kinds of investment the government wishes to promote and reducing the revenue forgone by limiting incentives to the appropriate class of individuals and entities. Targeting may well determine how successful or cost-effective an incentive will be.[1759] **Michael Honiball** observed that there was a perceptible attenuation of tax incentives with the decline of the Strategic Investment Programme, Industrial Development Zones' tax holidays and the apparent replacement of these with financial incentives such as the cash grant

[1759] Easson, *Tax Incentives for Foreign Direct Investment, op cit*, chapter 5.

under the Motor Industry Development Programme. However, there was a recent resurgence of tax incentives by way of accelerated deductions of R&D expenses in terms of §11D, ITA.[1760]

This view was corroborated by **Martin Grote** (Chief Director of Tax Policy/Head of Tax Unit, South African National Treasury) during a teleconference interview with this Researcher.[1761] He stated that South Africa presently has a strong aversion to tax incentives. Tax incentives were increasingly perceived as 'quick fixes' which generally did not resolve long-standing industrial, infrastructural and economic problems. As such, tax incentives were being phased out to a large extent and replaced by other non-fiscal measures such as duty rebates, subsidies and grants. The only exception to this general rule was in respect of R&D which the government was encouraging by targeted incentives in terms of §11D, ITA.

Nigerian incentives remain rather blunt, diversified and unresponsive to changes in current economic realities. As discussed below in **§7.4.3.2**, the proliferation of pioneer incentives for 'infant industries' has led to the rise of a de facto 'infant economy'. Nigeria could learn much from South Africa in implementing the Draft NTP policy prescription of steam-lining tax incentives to restrict their use to instances where they help to achieve a national objective that cannot be achieved more efficiently in any other way.[1762]

7.3.2.2. **Fitness For Purpose**

South African tax incentives often feature special techniques such as ring-fencing and claw-back provisions to ensure that they remain cost-effective tools to achieve desired policies. The reform of South African tax incentives has been a progressive, incremental affair that has seen blunt measures like tax holidays being replaced with more cost-effective measures such as the Strategic

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[1760] Interview with Michael Honiball, *op cit.*

[1761] Teleconference Interview with Martin Grote: Chief Director of Tax Policy/Head of Tax Unit; South African National Treasury Department, Pretoria, South Africa (London-Pretoria, Fri 29 June 2007).

[1762] Draft NTP, p.22.

Industrial Projects' incentives. Even these new measures are being phased out as results indicate that non-fiscal measures may be more effective. The operative rule appears to be using measures that are fit for the purpose intended. An example of this approach can be seen in the phase-out of the Strategic Industrial Projects.

Ian MacKenzie (Head of Corporate Tax, Webber Wentzel Bowens) observed that it has been unclear to the business community whether the Strategic Industrial Projects programme was designed to promote investments in plant or in personnel.[1763] The incentives emphasised capital-intensive investments as, at the time, the government believed machines were essential for development. However, there may have been a policy mismatch in tying incentives to high capex thresholds and still expecting the investors to reduce unemployment by creating jobs particularly in modern, computerised and high-tech manufacturing. Whether or not this programme was deemed to be a success had not been officially published. In his opinion, it could be that the decision to discontinue the programme was evidence that it was not as successful as expected.[1764] The Strategic Industrial Projects created jobs and promoted investment but it is unclear how many of these projects would have gone ahead without the incentives. To the extent that this proportion was large, the incentives were redundant. His view was that the government had not been able to accurately target marginal investments. As such, many investors may have gone ahead with sound investments which would only have been made better by the incentives.

Theses views were confirmed by **Martin Grote**.[1765] He noted that there was ongoing work on a report to assess the merits or otherwise of the Strategic Investment Project incentive scheme.[1766] However the general consensus that

1763 Interview with Ian MacKenzie, Head of Corporate Tax, Webber Wentzel Bowens (Johannesburg, Fri 18 May 2007).

1764 Alternatively, the desired objectives had been achieved and there was no need to continue the incentive regime.

1765 Interview with Martin Grote, *op cit*.

1766 However, this report was confidential and Martin Grote declined to discuss it.

the scheme was expensive and costly: R3billion was spent by way of tax expenditures yet only R10billion in investment was generated. More crucially, the main object of the programme was job creation line with a government employment target for 2014. Only 7,000 jobs were created at an average cost of R428,571 per job. Consequently, the scheme was not seen to be a cost effective way of increasing employment and this contributed to the decision to discontinue it. Other means of promoting job creation have been pursued including job training allowances, apprenticeship schemes deductions etc. Finally, Martin Grote noted that as many of the Strategic Investment Project investments were very profitable it is probable that there were high levels of incentive deadweight and redundancy rates as many projects would have proceeded without the incentives creating windfall gains for investors.

A review of energy sector tax incentives in 2000 found Memorandum of Understanding incentives for Nigerian petroleum operation companies to be broadly appropriate.[1767] However, it is unlikely that most Nigerian tax incentives would pass the test of fitness for purpose. Policy statements favour accelerated depreciation and investment tax credits to promote investment in productive assets.[1768] Like the South African Strategic Investment Projects, such a policy may lead to large revenue losses and redundancy rates if investors would have invested in any case. Besides discouraging the assimilation of newer technologies and techniques, this policy may distort investment in favour of plant over personnel hampering efforts at job-creation.

Admittedly, certain economic sectors (e.g. energy) traditionally employ high levels of capital and low levels of labour. However, it is precisely in such sectors that the Nigerian government seeks to create jobs, promote greater local content inputs and balance ethnic participation based on the 'federal

1767 ¶19, Nigeria: Letter of Intent and Memorandum on Economic & Financial Policies of Federal Government for 2000, dated July 20, 2000.

1768 Olabode M. Agusto, Director-General, Budget Office of the Federation; Presentation on 'The Role of Tax Policy in Driving Economic Growth and Development in Nigeria', *op cit*, slide 17.

character' principle.[1769] Combining these social objectives with a fiscal policy that favours capital-intensive production may prove counterproductive if not well conceived or implemented. Finally, where infrastructural deficiencies such as erratic power supply remain unresolved it is difficult to see how incentives for capital investment, however well suited for purpose, would deliver the desired results. Happily, the Draft NTP addresses this problem by targeting pioneer holidays to private investments in infrastructure and basic services.[1770]

7.3.2.3. Sound Economics or Petty Politics?

On February 20, 2008 South Africa's **Trevor Manuel** in his Budget Speech noted that '... this House and every taxpayer shares with us a responsibility to question continuously whether our incentives are based on sound policies and criteria, not on favours or special interests masquerading as the public good'.[1771] Where tax incentives generate political as well as economic dividends, care must be taken to honestly determine the precise rationale for these incentives. Although it may be convenient to conceal political motives under a veneer of sound economics, when the associated incentives cease due to political or other changes, investors may withdraw from the sectors unravelling any economic gains achieved.

Ian MacKenzie made similar observations while assessing the historical approach to tax incentives in South Africa over the years.[1772] Between the 1960s and 1990s, certain tax incentives were used for political rather than economic reasons. As noted in **§4.2.5.2** above, incentives were given to industrialists to relocate manufacturing plants to rural areas ostensibly to promote the decentralisation of industry and reduce congestion in heavily industrialised areas. Such incentives included tax holidays, accelerated depreciation and investment allowances. However, the industrial decentralisation scheme also

[1769] The Federal Character Commission enforces constitutional provisions prohibiting the predominance of persons from a few states or ethnic groups in the federal government or its agencies: see §§14 & 153, CFRN 1999.
[1770] *Appendix Two: Strategy for Implementation of the Proposed Policy,* Draft NTP, p.26.
[1771] SA 2008 Budget, p.10.
[1772] Interview with Ian MacKenzie, *op cit.*

had the political objective of promoting racial segregation under *apartheid*.[1773] As the underlying motives of the policy were more political than economical, the scheme encouraged otherwise economically unviable investments in rural areas. Unsurprisingly, when the incentives were withdrawn much of these investments were discontinued as they were unsustainable. Other adverse effects were instances of abuse and sharp practice.[1774]

Tax incentives in Nigeria have rarely been used so overtly for political reasons. However, adverse political conditions have played a role in the grant of very generous incentives. Omorogbe has criticised the generosity of incentives under the NLNG/FIGA Act as the attempt by the then military government to legislate for stability in the unstable, politically-charged investment environment of the early 1990s.[1775] Happily, Nigeria now has a relatively stable, democratically-elected government. However, as **Kofo Dosekun** (Partner, Aluko & Oyebode) observed the NLNG incentives were continued for ten years despite the restoration of a significant degree of normalcy to the polity in the late 1990s.[1776] Contemporary political objectives that may creep into investment incentive policy include maintaining 'federal character' in official appointments in public enterprises, promoting the employment of indigenous individuals in multinational firms and encouraging local content in subcontracting and production. The constraints imposed by WTO rules on local content provisions have been highlighted in Chapter 6. Nigerian policymakers should carefully weigh the merits of advancing political ends through tax incentives against the risk of the distortions that incentives inherently create. As with South Africa, it may be that any political gains prove to be transient while negative economic consequences endure.

1773 Black, 'Decentralization incentives and investment in the South African periphery', *op cit*, pp.121-141.

1774 Ian MacKenzie mentioned the typical scheme of claiming more jobs had been created than was the case to enjoy unduly generous incentives tied to job creation.

1775 Omorogbe, 'Law and Investor Protection in the Nigerian Natural Gas Industry', *op cit*, pp.188-191.

1776 Interviews with Mrs. Kofo Dosekun: Partner, Aluko & Oyebode (Lagos, Fri 26 and January and Thurs 08 February 2007).

7.3.2.4. Count the Cost Wherever Possible

Ian MacKenzie made certain practical observations regarding cost-benefit assessments of tax incentives.[1777] Companies who benefit from incentives would always emphasize the merits of incentives but how does one really measure their tangible benefits? If investments are viable without incentives, their grant may lead to high redundancy rates and large costs in revenues forgone. If investors insist that incentives are essential for marginal investments, how shall these assertions be proven empirically?

Bolnick recommends the use of marginal effective tax rates (METRs), tax expenditure budgeting and explicit screening criteria as three techniques that policymakers could use to analyse the efficacy of tax incentives.[1778] South Africa has utilised tax expenditure budgeting in setting financial ceilings for incentive schemes such as the Strategic Industrial Projects (set at R10billion). **Martin Grote's** suggestion that the scheme was perceived to be wasteful was based on the cost-benefit assessment of the R10billon spent in tax expenditures. However, Martin Grote noted that while Bolnick's recommendation of marginal effective tax rates is an interesting point, these have not been used in South Africa due to the data-intensive nature of the analysis required. Bolnick's analysis was only in respect of a circumscribed data set. Martin Grote suggested that METR analysis may have been conducted for individual projects but not for the general tax incentive regime. Consequently, South Africa could not presently conduct METR analysis for all possible tax incentives in diverse economic sectors.[1779]

Nevertheless, South Africa usually provides, as part of its national budget, a tax expenditure estimate of the cost of tax incentives to the fiscus in terms of revenues forgone. Luja suggests that where such tax expenditures are excluded from the national budgeting process, this undermines fiscal transparency and

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1777 Interview with Ian MacKenzie, *op cit.*

1778 Bolnick, *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, *op cit*, chapter 4.

1779 Interview with Martin Grote, *op cit.*

prevents politicians and taxpayers alike from perceiving the true fiscal impact of these measures.[1780] He notes the observation by certain commentators that such fiscal opacity is often a deliberate ploy by politicians or policymakers to conceal tax expenditure from probing public scrutiny or to reduce lobbying by interest groups for similar incentives. However, he argues that while cash subsidisation may increase fiscal transparency, it may further complicate income tax systems, and increase administrative costs and burdens for both tax authorities and taxpayers. He concludes that: '(like) any other kind of government subsidisation tax expenditure requires an in-depth analysis and discussion about its necessity in the public interest.'[1781]

This Researcher did not find any indication of any studies or reports which empirically considered the costs and benefits of Nigerian tax incentives using tax expenditure budgeting or METRs. Given the dearth of reliable statistical data on the Nigerian tax system in general and tax incentives specifically, it is likely that any such analysis would encounter significant difficulty. However, for incentives tied to petroleum operations there may be sufficiently accurate data sets available from the Department for Petroleum Resources and the FIRS' Oil and Gas Department to arrive at reliable results. The significance of petroleum tax revenues to Nigeria underscores the importance of such a study. The use of these techniques may derive information on energy sector incentives that may be useful in identifying redundant incentives for withdrawal and effective incentives for greater targeting. Tax expenditure budgeting would also be useful on wider scale to assess the cost of fiscal incentives provided in other economic sectors. However, given Nigeria's complicated system of allocating federal revenues among the states and local governments, it is likely that tax expenditure budgeting would provoke contests among various constituencies jostling for greater shares in the allocation of tax expenditures.

[1780] Luja *Assessment & Recovery of Tax Incentives in the EC & the WTO*, *op cit*, pp.14-19.
[1781] *Ibid*, p.19.

7.3.2.5. Adequate Consultation with the Private Sector

The South African experience indicates that consultation with private sector interests – the intended recipients of tax incentives – is imperative. This Researcher found that in respect of §11D, ITA R&D incentives, there was a prevailing private sector perception that there had been inadequate consultation regarding the new incentives. [1782] **Martin Grote** strongly disagreed.[1783] He noted that tax legislation in South Africa goes through a very public process involving the public, private sector, media and parliament. Consultation is also conducted electronically. When policy measures are proposed, there is adequate public consultation. When draft bills are sent through parliament, there is yet more consultation. There are procedures where public input can be given to the portfolio and other committees that examine draft laws and policy proposals. All these processes occur before the policies of the Minister of Finance eventually become law. [1784] As such, the private sector had sufficient opportunity to be consulted on tax incentive and other tax legislation. Grote attributed the criticism of the private sector to the fact that all legislation is the outcome of compromise: no one gets all they want as not all proposals are affordable or practically workable. As such, there would always be dissatisfaction with the outcome and this fuelled complaints of inadequate consultation.

Ian MacKenzie presented a particularly balanced private sector perception of the issue of adequate consultation. MacKenzie explained that incentives are a manifestation of the larger issue of the government's challenges with fiscal policy implementation. Often, at higher policy levels, policy is agreed upon to promote a particular set of strategic objectives. However, SARS would be charged with drafting legislation and by the time this was produced, the intent of the policy may have been defeated by the restrictive manner in which the legislation was drafted rendering it unworkable. More piecemeal reform would

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[1782] Interview with Michael Honiball, *op cit.*
[1783] Interview with Martin Grote, *op cit.*
[1784] Grote gives the example of the *Royalties Bill* which has been in the pipeline since 2003 and was still undergoing consultation.

then be proposed to remedy this lapse. In his opinion, consultation with private sector could improve. In the past, SARS' distrust of private sector inputs was exhibited in narrow windows for consultation procedures and criticism of private sector views. MacKenzie conceded that the private sector often pursued narrow sectarian agendas which conflict with the need for policy to take a broader view. However, as a result of SARS not taking into account private sector views resulting legislation may be practically unworkable.[1785]

MacKenzie gave the particular illustration of the R&D incentives. Here, there was a clear policy espoused by government to promote investment in R&D. When SARS came out with the legislation without sufficient consultation it was unworkable in many respects. For instance, the definition of what constitutes R&D was so vague that there were few objective standards. Effectively SARS decides what qualifies as R&D. Further, there was a requirement that the Minister of Science & Technology should be given a report in 'in such form and manner (including electronically) and at such place as that Minister may from time to time prescribe'.[1786] In practice, the Minister had not yet given this much thought and issued regulations about modalities for the submission of such a report.[1787] Such deficiencies render the R&D incentives illusory.

Recently SARS has been taking input from selected members of the private sector whom they trust and this has helped to make legislation such as those on corporate rules regulating business organisations and mergers more workable in achieving policy objectives as well as being accessible to taxpayers.[1788] Although there are meetings between the President and leading businesspeople, these deal with high level policy as opposed to detailed application.

[1785] Interview with Ian MacKenzie, *op cit.*
[1786] §11D(11) & (12), ITA.
[1787] Moreover, the Minister will report to Parliament on the investor's report; as such, the provision seems geared more to improving Parliamentary oversight and less to helping to SARS decide whether to grant the incentives or not.
[1788] Apparently, MacKenzie was consulted in this process.

The Draft NTP is essentially the product of a partnership between the Nigerian government and the private sector. There were significant private sector influences at all stages in its formulation. At the relevant time the Budget Office's Director-General, the Federal Minister of Finance and the Chairperson of FIRS were all accomplished private sector professionals that had been appointed to serve in the public sector. This development is welcome and should be continued. However, care should be taken to ensure that a balanced view to tax incentive policy is adopted to prevent private interests from subverting policies to serve narrow, sectarian ends. The wellbeing of Nigerians, as taxpayers and consumers of public goods and services, should remain paramount.[1789]

7.3.2.6. **Tax Policy is Tax Administration**

Tax policy tends to be only as effective as its administration. Discretionary approvals have been identified as features that increase the scope of mismanagement of tax incentives. **Martin Grote** observed that the South African government seeks to ensure that where tax incentives are granted, they are designed to reduce the scope of discretion involved. Incentives such as those for the Strategic Investment Projects which require considerable discretion have been phased out and the preference is for incentives with automatic approval procedures.[1790]

Ian MacKenzie traces a distinct change in South African tax administration in the last decade. The period between 1994 and 1998 was characterised with low taxpayer morality acerbated by poor tax administration. However since 2001, SARS has changed the face of tax administration by evolving into a more efficient and effective organisation with better skilled and remunerated staff who are focused on revenue collection. Although SARS' new vigorous application of tax laws is a good development which has lead to increased

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1789 Draft NTP, p.3.
1790 Interview with Martin Grote, *op cit.*

revenues, the effect of the new aggressive drive has been felt mainly by the larger taxpayers.[1791]

While the SARS aggressive revenue drive has resulted in revenue projections being consistently exceeded in recent years, it appears to have contributed to a decline in taxpayer morality. Professional tax advisers complain that SARS' often pursues unreasonable disputes relentlessly even where the revenue's position is clearly untenable. **Ferdi Vorster** and **Robyn Nathan** (Director, Corporate Tax; Partner, International Tax: KPMG South Africa) observe that this issue of tax morality vs. legal obligation to pay tax is a growing issue which is now widely debated. SARS argues for tax morality and insists that taxpayers should render returns as due. However, SARS's aggressive attitude discourages clients and investors from seeking fiscal incentives given SARS' reluctance to grant any incentives at all possibly undermining the government's economic and social development goals.[1792]

The implications of tax administration for the execution of Nigerian tax incentives are considered at length below in **§7.4.3**. From However, as seen in the South African experience, tax administration is a critical factor in tax incentive design, implementation and review. The next section considers what lessons may be gleaned from the Kenyan experiences with tax incentives, particularly those for special sectors like agriculture and exports.

1791 Interview with Ian MacKenzie, *op cit.*

1792 Interview with Ferdi Vorster: Director, Corporate Tax and Robyn Nathan: Partner, International Tax; KPMG Services (Proprietary) Ltd, KPMG RSA National Office (Johannesburg, Thurs 17 May 2007).

7.3.3. Lessons from Kenya

7.3.3.0. Introduction

As seen in Chapter 5, the Kenyan tax incentive regime is a relatively simple one compared to those of Nigeria and South Africa. Key incentive policies target agriculture, export-oriented manufacturing and tourism. While more research might have yielded greater insights into the Kenyan tax incentive system, the following lessons may nevertheless be learned from Kenyan experiences.

7.3.3.1. Simplicity is Golden

Dr. Gavin McEwen (former Head of Tax/Senior Tax Partner: PricewaterhouseCoopers, Nairobi, Kenya) observed that from his experience of negotiating tax concessions for Kenyan multinationals, tax incentives were reluctantly given by KRA even where significant investments where being made in priority sectors such as mining and manufacturing. In general, fiscal policy favoured few tax incentives provided precisely in line with existing legislation with a view to maintaining equity across taxpayers.[1793] Gavin McEwen noted that while KRA's administrative capacity had improved over the years (particularly in the use of information technology) there were still administrative shortcomings such as maintaining sufficiently reliable taxpayer records to facilitate routine tax audits. It stood to reason that if maintaining taxpayer records consumed so much administrative capacity, resources would be better allocated to improving this capacity rather than monitoring tax incentive programmes.

7.3.3.2. Consider Non-Tax Incentive Measures for Special Sectors

Agriculture is Kenya's primary economic sector and there are numerous tax concessions granted to agriculturalists by way of VAT exemptions and capital allowances. However, **Gavin McEwen** considered that these concessions are not materially different from concessions granted in other countries where

[1793] Interview with Gavin McEwen: former Head of Tax/Senior Tax Partner, PricewaterhouseCoopers, Kenya; at the Caledonian Club (London, Weds 21 November 2007).

agriculture is a significant economic sector. He saw these concessions not as tax incentives *per se* but rather measures which seek to recognise the peculiarities of agricultural enterprise such as the seasonal nature of cultivating and harvesting crops. Such measures should be encouraged and this pragmatic approach to the design of tax incentives is desirable. In his opinion, as tax incentives usually operate at the margin and rarely are the critical factor determining investment decisions, care must be taken to target incentives in such a manner as to actually achieve the desired policy objective. In certain circumstances, this may not require the use of tax incentives but rather a pragmatic appreciation by the relevant tax authority of the commercial realities of the taxpaying enterprise.

He gave the example of incentives for mining activities: a greenfield mining company's profile typically features negative cashflows in the early years followed by positive cashflows in later years. Offering this company an initial tax holiday is not very meaningful in the absence of loss and capital allowance carry-forward provisions. Indeed, this company may prefer import waivers or concessions given the large amounts of capex incurred in early years. Unless tax policymakers appreciate the particular circumstances of the taxpayer, ineffective tax incentives may be offered which may prove counterproductive in the long term.

7.3.3.3. The Need for Dynamic, Sustainable Tax Incentive Policy

In this era of regional integration and open international trade, tax policymakers must consider the impact of regional and international trade commitments on fiscal policy. **Gavin McEwen** noted that the less-than-seamless transition of powers over duty exemptions and VAT/import duties remissions from the KRA in Nairobi to the EAC CU in Arusha had an adverse impact on Kenyan taxpayers seeking duty remissions. He observed that care should be taken to ensure that while tax incentive policy remains dynamic enough to maximise international trade opportunities, global trends are carefully analysed to avoid large revenue losses arising from excessively generous incentives.

Case in point was the Kenyan EPZ regime. While the EPZ incentives have created significant investment and employment in garment production and manufacturing, many of the EPZ firms were of the footloose variety, attracted more by third-country opportunities under AGOA and other trade agreements than Kenya's economic fundamentals. **Gavin McEwen** believes there is considerable risk that when these preferential trade opportunities expire these firms would simply relocate to other locations taking with them the jobs and investment. To his knowledge, some EPZ enterprises had wound-up operations over marginal reductions in the amounts of goods that could be sold in the Kenyan custom area. Given the ease with which EPZ enterprises could cease operations and relocate to other jurisdictions, any perceived gains from EPZ regimes should be dispassionately appraised and greater attention directed at targeting more enduring investment.

7.3.3.4. Tax Policy is Tax Administration

If the administrative capacity to implement policy initiatives is lacking or inadequate, the efficiency and effectiveness any fiscal initiative would inevitably be undermined. Case in point was the use of tax incentives to promote manufacturing and job creation. **Gavin McEwen** considered that the informal/SME sectors may have a greater potential to create employment for thousands of Kenyans than manufacturing given the global shift to service-oriented enterprise. [1794] However, it was only recently that the Kenyan government had encouraged SMEs. Under the Moi regime large multinational businesses were feted while few policies were implemented to directly improve the fortunes of smaller enterprises. [1795] Some recent policies such as the introduction of a **turnover tax** in early 2008 may ease the tax burden on SMEs

[1794] Indeed, most of the 471,000 jobs created in 2005 were in the informal sector: OECD/AfDB, *African Economic Outlook 2007: Country Notes (Kenya)*, p.314.

[1795] Gavin McEwen observed that this 'big business' hang-over still persists in practices like KRA's annual award ceremonies celebrating the largest taxpayers who invariably are large multinational companies: Interview with Gavin McEwen, *op cit.*

by reducing the degree of accounting records to be maintained in filing tax returns.[1796] However, in other areas the KRA's administrative record is clearly inadequate.

Gavin McEwen gave the practical example of VAT refunds. While the use of withholding methods to collect VAT has increased the level of receipts, KRA's handling of VAT refunds had negative implications for many SMEs. All revenue collections by the KRA are remitted to the Treasury. Consequently, KRA only has access to such funds that the Treasury budgets for refunds and in reality, there are never enough funds to cover all legitimate applications. In theory, the process involves securing official approval for the refunds, passing certain technical checks or audits, and obtaining cash-office authorisation. In practice, the assistance of senior revenue officials is often sought to ensure that a client's refunds comes through in the monthly refund 'round'.

Gavin McEwen observed that in the past, it was common knowledge that the use of political connections and outright graft was sometimes utilised by unscrupulous and unprofessional individuals to secure refunds. In these circumstances successful refunds were often dependent on the ability of a taxpayer to engage professional tax consultants,[1797] wield sufficient political clout or in certain cases, exploit corrupt revenue officials. Smaller enterprises that lacked political connections or professional tax advice often could not secure VAT refunds. The resultant cash-flow problems contributed to the demise of many smaller enterprises, discouraging others from seeking VAT registration. In Gavin McEwen's view, resolving this critical lapse in the VAT refund system would provide a much greater fiscal encouragement for SMEs than many of the tax incentives targeted at SMEs. Happily, proposals under the 2007/2008 Budget seek to address these issues by increasing funds dedicated to the monthly refund 'rounds' and introducing a fast-track processing

[1796] PricewaterhouseCoopers Kenya, 2007 Budget Bulletin: Direct Tax, p.3.

[1797] Gavin McEwen noted that this was an important function PricewaterhouseCoopers performed for many multinational clients in Kenya: Interview with Gavin McEwen, *op cit.*

procedure.[1798] However, it remains to be seen how effective these measures will be.[1799]

An important factor determining the quality of any revenue authority's tax administration capacity is the calibre of staff that authority can attract, train and retain. Gavin McEwen drew an interesting distinction between KRA and South Africa's SARS. While professional consulting firms like PricewaterhouseCoopers regularly recruited outstanding KRA staff, their South African-based tax professionals were regularly 'poached' by SARS evidently enticed by offers of better remuneration and service conditions. The significantly different administrative competencies of SARS and the KRA highlighted the positive impact of SARS's latitude to operate independently from civil service controls. By investing a small percentage of revenue receipts in funding operations and the remuneration of first-class professionals, SARS was able to build sufficient tax capacity to drive record collections, increase gross revenues, reduce tax evasion and ultimately finance tax reductions and concessions.[1800]

Conversely, highly-skilled Kenyan tax professionals often were discouraged from working in the KRA due to perceived poor service conditions. Indeed, **Christine Muga** (Tax Associate: PricewaterhouseCoopers Channel Islands) observed that the fact that the KRA's Commissioner General was a former Ernst & Young tax partner did not seem to encourage more junior tax professionals to seek careers with the KRA.[1801] There was also the reality that political or ethnic considerations were often more critical to advancement or

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1798 K Budget Speech 2007/2008, p.28.

1799 PricewaterhouseCoopers Kenya, 2007 Budget Bulletin: VAT, p.1.

1800 In 2006, SARS' tax collections increased by 4.5% (VAT/indirect tax: 14.5%; corporation tax: 18.1%) due to higher domestic demand, broadening the tax base and strong tax compliance: OECD/AfDB, *African Economic Outlook 2007: Country Notes (South Africa)* p.491.

1801 Statement by Christine Muga: Tax Associate, PricewaterhouseCoopers Channel Islands; formerly of Ernst & Young Eastern and Central African Advisory Services' Tax Department, Nairobi, Kenya: (personal communication 7 December 2007).

promotion than mere merit or technical competence.[1802] Unless the KRA was able to address these perceived lapses it would be unable to fully unleash the full potential of its staff further undermining its administrative capacity to deliver on tax incentives and other policy initiatives.

7.3.4. **Outcomes**

The foregoing discussion in **§7.3** has outlined lessons that Nigeria could learn from the South African and Kenyan experience of utilising tax incentive policy to promote investment, trade development and economic growth. However, the successes of South African and Kenyan tax incentive policies have been greatly influenced by local conditions prevalent in these jurisdictions. As such, the direct applicability of these lessons must be considered in light of the local factual and cultural circumstances obtaining in Nigeria. The next section (**§7.4**) considers some constraints on Nigeria's ability to learn from the South African and Kenyan experiences due to such local peculiarities.

1802 Gavin McEwen observed that some (unnamed) revenue officials had blamed their lack of advancement on being from the 'wrong' ethnic group: Interview with Gavin McEwen, *op cit.*

7.4. Constraints on the Applicability of Lessons from Regional & International Experiences

7.4.0. Unique Aspects of the Nigerian Fiscal Environment

The previous section (§**7.3**) has highlighted key lessons from the South African and Kenyan experiences which may be useful in improving the design, implementation and review of Nigerian tax incentive policy. However, the Nigerian tax system differs fundamentally in many important respects from those operative in South Africa and Kenya due to historical, political, economic and cultural reasons. In this Researcher's opinion, some of these differences are crucial in understanding the possibilities for and limitations on the application of these lessons to Nigerian tax incentive policy. This section (§**7.4**) explores some of these differences and considers their impact on the applicability of the exemplars derived from South Africa and Kenya.

7.4.1. Tax Morality & Nigeria's 'National Cake'

Robyn Nathan raised the interesting possibility of tax morality being impaired by SARS' aggressive revenue-maximising attitude.[1803] Tax morality in South Africa has traditionally been relatively high compared to what obtains in other Sub-Saharan African countries due, in part, to historical, political and economic conditions. Liebermann notes that '... in South Africa, where a unitary and racially exclusionary definition of NPC[1804] produced more coherent class relations within the white polity, analogous upper groups have largely accepted the state's demand for progressive taxes' ensuring that the '... policies of deliberate racial *exclusion* were responsible for a legacy of a much more effective and progressive tax system, such that black South Africans today benefit from that legacy...'[1805] Liebermann emphasises this causal relationship between the racial and political realities of the pre-*apartheid* period and the development of an effective, progressive and cooperative tax system characterised by high levels of tax morality, significant voluntary tax

[1803] Interview with Ferdi Vorster and Robyn Nathan, *op cit*.

[1804] Liebermann defines NPC (or National Political Community) as the group of people officially entitled to the rights and responsibilities of citizenship: Liebermann, *Race and Regionalism in the Politics of Taxation in Brazil and South Africa*, *op cit*, p.3.

[1805] *Ibid*, pp.122,271.

compliance and relatively few, highly-targeted tax incentives.[1806] Conversely, in rentier states, Liebermann notes that the ease of extracting mineral or other natural resource rents from a particular, high-value economic sector may result in less emphasis on deriving revenues from broad-based direct taxes in other sectors.[1807]

Tax morality in Nigeria is an almost alien concept. However, the aversion of everyday Nigerians to paying tax stems predominantly from the pervasive perception that the Nigerian state has repeatedly failed in keeping its side of the social contract by providing security, infrastructure and basic services to the common man. **Derrick Wogu** (Tax Manager, British American Tobacco [Nigeria] Ltd) confirmed this private sector perception, arguing that while in theory, the Nigerian fiscal regime looks attractive with generous allowances, numerous incentives and relatively low VAT, personal and corporate income tax rates, the reality faced by local and multinational companies is of inadequate incentives for investment due to poor coordination of taxes and the lack of basic services. In his view, there was precious little value to be had for taxes paid where businesses were taxed on income, capital and salaries yet had to provide their own infrastructure in terms of security, water supplies, electricity, roads, transportation, postage delivery and other services one would expect a functional state to provide.[1808] It may be recalled that the findings of both the Study Group and the Working Group corroborate this view. Both Groups concluded that the best tax incentive was the judicious use of fiscal resources to improve infrastructure and so enhance taxpayer morality and compliance.

Consequently, a strong sense of tax morality cannot thrive among Nigerian taxpayers where corruption and mismanagement are perceived to be continually perpetuated by politically exposed persons. Critical citizens legitimately

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1806 *Ibid*, p.59.
1807 *Ibid*, p.58.
1808 Interview with Derrick Wogu: Tax Manager, British American Tobacco (Nigeria) Limited, BAT Headquarters (Lagos, Tues 13 February 2007).

wonder what exactly, by way of infrastructure and services, the Nigerian state can show for decades of collecting trillions of Naira in taxes, oil rents and other fiscal resources. Indeed, **Ifueko Omoigui** (FIRS' Chairperson) tellingly observes that '...the government also needs to win the trust and confidence of people if we are to get them to pay taxes. If the hard-earned money they pay to the government's coffers is being stolen or misused, they will do everything to evade tax'.[1809] Poor fiscal accountability among political office holders and the dearth of sufficiently punitive consequences for corruption discourage tax morality and this undermines the fiscal system through which tax incentives are provided.

An ancillary issue is the local metaphor of the 'national cake' symbolising how opportunities, wealth, influence and power are shared or otherwise distributed among the individuals, constituencies, ethnic groups, states and regions that constitute Nigeria. There are positive aspects of this 'national cake' metaphor such as the 'federal character' principle which posits that such opportunities be shared equitably among these constituencies.[1810] However, the 'national cake' metaphor is more usually associated with the negative, rent-seeking attitude of individuals or groups who seek to divert such opportunities for selfish aggrandisement or sectarian exploitation. Corrupt politically exposed persons are wont to argue that graft is simply their means of 'obtaining their piece of the national cake'.

Both these concepts – tax morality and the 'national cake' – are important in understanding local attitudes and perceptions to tax incentives. For instance, unscrupulous investors may seek to exploit loopholes in tax legislation to access incentives which they are clearly not entitled to, justifying such undesirable conduct as their opportunity to 'grab their piece of the national cake' by using publicly-funded tax expenditures to finance the reduction of

[1809] O Obayiuwana, Interview with Omoigui Ifueko, Chairperson, FIRS: O Obayiuwana, 'Are Nigerians ready to pay tax?' *BBC News/Africa* news article (London 6 June 2005) <http://news.bbc.co.uk/2/hi/africa/4614121.stm> accessed 26 September 2007.

[1810] §§14 & 153, CFRN 1999.

private commercial risks or the enhancement of rates of return on private investment. Conversely, investors might decline to invest in projects that have high social rates of return but low financial rates of return, arguing that it was the role of the public sector, not private enterprise, to 'bake more national cake' by developing public infrastructure or providing basic services for modest profit.

These issues pose several implications for the role of tax incentives in Nigeria. First, if tax incentives are not properly designed and targeted at specific sectors perceived to pose real opportunities for the cost-efficient use of such measures, incentives may be exploited by rent-seeking, politically connected persons with low tax morality, seeking to extract their 'share of the national cake' by unduly accessing incentives. Indeed, the recent suspension of discretionary import waivers and other tax exemptions by the current Federal Minister of Finance, **Dr. Shamsuddeen Usman**, has been attributed to the abuse of such preferences by persons connected to the previous Obasanjo government leading to large customs and tax revenue losses.[1811]

Secondly, in such conditions of low tax morality automatic approval mechanisms are clearly preferable to the discretionary grant of incentives given the real risk of corruption and abuse. An enquiry has being made into the degree of compliance of the recently-suspended exemptions and waivers with due process amid allegations that presidential discretion was abused in certain instances.[1812] Finally, an administrative environment of regular monitoring, rigorous review, constant disclosure and fiscal transparency would reduce the incidence of tax preferences being granted to the few resulting in their competitive advantage over the many in key economic sectors. It is only when the fiscal regime is perceived to be fairly administered, tax revenues are properly applied to the provision of security, infrastructure and basic services,

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[1811] Mathias Okwe, 'Govt Suspends tax, import waivers,' *Nigerian Guardian* (Lagos 24.08.07) <http://www.guardiannewsngr.com/news/article01> accessed 24.08.07.

[1812] Kunle Aderinokun, 'FG Audits Tax Waivers, Exemptions' *This Day* (Lagos 28.07.07) <http://www.thisdayonline.com/nview.php?id=90703> accessed 28.07.07.

and corruption on the part of politically exposed persons is vigorously discouraged by real and severe penalties that tax morality among taxpayers would improve.

In this Researcher's opinion, this enhanced sense of tax morality would in turn improve the effectiveness of any tax incentives in that only those persons legitimately entitled to incentives would tend to seek them and those not entitled would tend to be more conscientious about paying their taxes as and when due to play their part in baking and not taking from the 'national cake'.

7.4.2. Politics: Policy Inconsistency, Fiscal Federalism & Rule of Law

Nigeria has experienced significant policy changes since independence. In recent years, the general trends have been in line with the Vision 2010/2020 and NEEDS agendas which remain quite consistent in outlook. However, policy inconsistency and reversal is a major impediment to implementing national economic plans. Nigerian ministers and functionaries, on assuming office, are notorious for suddenly scrapping existing policies often in a bid to stamp their individuality on policies and administration. Sudden, unexpected policy reversals are the norm, undermining policy consistency and impairing the ability of the private sector to plan ahead and respond to opportunities and challenges in the investment environment.

Recent instances of policy inconsistency include the dramatic reversal of the CBN's Naira re-domination policy ostensibly for non-compliance with due process,[1813] the cancellation of the sale by privatisation of the Port Harcourt and Kaduna petroleum refineries by the Obasanjo government to certain well-connected private investors[1814] and the VAT rate increase policy reversal discussed at length in **§6.4.6** above. Yar'Adua's new 7-Point Agenda is increasingly replacing the NEEDS framework as the national economic

[1813] Madu Onuorah, 'Why Govt Suspends Naira Denomination Policy,' *Nigerian Guardian* (Lagos 26.08.07) <http://www.guardiannewsngr.com/news/article02> accessed 26.08.07.

[1814] Godwin Haruna, 'A Sale Too Many' *This Day* (Lagos 20.07.07) <http://www.thisdayonline.com/nview.php?id=84083> accessed 20.07.07.

blueprint. The 7-Point Agenda focuses on power and energy; food security and agriculture; wealth creation and employment; mass transportation; land reform; security; qualitative and functional education. Despite the broad correspondence of these issues with economic themes under NEEDS, the Yar'Adua administration seems to be at pains to differentiate these two policies.[1815]

In relation to tax incentives, there was the threatened withdrawal of tax incentives in 2005 from MTN Nigeria Communications Ltd by the National Assembly due to perceptions that the incentives were excessively generous. Ultimately, the incentives were retained due to high-level pressures applied by influential South African business interests on the Nigerian government.[1816] However, the uncertainty generated by the telecoms tax incentives debacle damaged Nigeria's investment image and increased perceptions of risk associated with investing in Nigeria.

Policy reversals also occur during the legislative process which transforms policy into law. It appears that under the original mining policy,[1817] tax holidays were to be replaced by a less liberal, more targeted cocktail under the *Minerals and Mining Bill 2006.*[1818] The Bill proposed to **replace current cumulative 5-year tax holidays** with **loss carry forward** provisions and a **low corporate tax rate** of between 20% and 30%. **Accelerated depreciation** by capital allowances were to be increased to 100% on qualifying capex coupled with

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1815 Emeka Anuforo, 'Yar'Adua orders review of NEEDS 2 framework,' *Nigerian Guardian* (Lagos 15.01.08) <http://www.guardiannewsngr.com/news/article05//indexn2_html?pdate=150108&ptitle=Yar'Adua orders review of NEEDS 2 framework> accessed 15.01.08.

1816 Cletus Akwaya, 'GSM: Five-Year Tax Holiday Still in Force, Says MTN CEO,' *Nigerian Guardian* (Lagos 06.05.05) <http://www.guardiannewsngr.com/news/article02> accessed 07.02.07.

1817 Proposed when Obi Ezekwesili was Federal Minister of Solid Minerals Development during the Obasanjo administration. Ezekwesili is now a Vice President at the World Bank.

1818 Federal Ministry of Solid Minerals Development's Mining Journal special publication, 'Nigeria: An Exciting New Mining Destination', *op cit*, p.6: Box 'Summary of the Fiscal Regime for Mining'.

deductions for exploration and other expenditure.[1819] However, as seen above in §**3.2.7.2** of this Thesis, NMMA 2007 presently provides for **cumulative 5-year tax holidays**.[1820]

One cause of policy inconsistency is the lack of clarity in defining the scope and extent of the responsibilities and authority of various functionaries, agencies, departments, ministries, and arms or indeed, tiers of government.[1821] **Derrick Wogu** highlighted the proliferation of overlapping, spurious state and local government taxes on vehicle emissions, advertising and vehicles licensing as a major impediment to inward investment. He observed that while legitimate user charges were valid, in many instances, unenlightened lawmakers and local government officials were desperate to increase revenues without providing any service or considering the broader, macroeconomic implications of their actions on inward investment and private capital formation.[1822]

Even where constitutional provisions appear to put these matters beyond cavil, some authorities ignore the clear letter of the law in their pursuit of greater authority or revenues. Recently, the Lagos State government sought to impose a stealth tax by way of an infrastructure levy on the erection of telecommunication masts, towers and other infrastructure under the *Lagos State Infrastructure Maintenance and Regulatory Agency (LIMRA) Act.*[1823] This law was challenged by the industry's umbrella Association of Licensed Telecommunications Operators of Nigeria (ALTON). ALTON contended that the law was unconstitutional as the regulation of telecommunications came

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[1819] Cf. reports indicating that the Bill would include exemptions for capital gains tax, stamp duties and VAT: see 'Nigeria's New Mineral and Mining Bill, 2006', *This Day* newspaper article contributed by Peter Leon of Webber Wentzel Bowens, 27th February, 2006 accessed at <http://www.thisdayonline.com/nview.php?id=41794> on 03.03.06.

[1820] §28 NMMA 2007.

[1821] As noted in §**3.1.2** above, taxing powers are shared between the various tiers of government in accordance with the Second Schedule to the CFRN 1999; the *Taxes & Levies Act 1998* also clarifies the allocation of legislative powers between tiers of government.

[1822] Interview with Derrick Wogu, *op cit.*

[1823] Suit No. FHC/L/CS/517/2006-LASIMRA Law AWRE by Justice Ibrahim Auta, February 2007.

under federal, not state, legislative competence.[1824] In his judgement, Justice Ibrahim Auta concurred, ruling that state's attempt to usurp federal legislative powers was unlawful.[1825]

Multiple-taxation is just one aspect of the wider contest over determining the boundaries of power over taxing powers, economic policy and fiscal federalism. In other instances, the outcome of this contest is the violation of the rule of law and due process. As **Richard Ough** (Member, FIRS' Tax Policy Research & Development Department) observed, there was a clear tendency in Nigerian tax system to treat the law as a malleable tool in policymaking leading to administrative decisions being taken without adequate consideration of either appropriate procedures or legal restrictions on the powers of the relevant functionary. In his opinion, this was the source of some of the difficulties encountered by FIRS' Tax Policy Research & Development Department in discerning the legal basis for many tax incentives, waivers and exemptions purported to have been granted to taxpayers often without complying with due process.[1826]

In this regard, lessons can be learned from the South African example of cooperation between the Ministry of Finance, the National Treasury and SARS *vis-à-vis* tax incentive policy formulation and implementation. According to **Martin Grote**, there is no conflict in roles between the SARS and the National Treasury. SARS is clear on its role as a revenue collection agency and not as an agency responsible for monitoring and implementing industrial policies. Both the Treasury and SARS report to the Ministry of Finance where tax policy is determined. The Finance Ministry ensures that the official tax incentive policy is common to both SARS and the Treasury, and duly reflected in their work.[1827]

1824 In terms of Items 46, 66 and 68 on the Exclusive Legislative List, Second Schedule to the CFRN, 1999.

1825 Mohammed Shosanya, 'Lagos has no right to regulate telecom operators,' *Daily Trust* (Lagos 02.03.07), p.30; Oluwaseun Ayantokun, 'Telecoms industry and the battle against taxation by States,' *National Tribune* (Lagos 01.03.07), p.19.

1826 Focus Group Discussion with Richard Ough and other members of the FIRS Tax Policy Research & Development Department, *op cit.*

1827 Interview with Martin Grote, *op cit.*

Sunet Myburg (Official, SARS) also corroborates this view. She confirmed that fiscal and tax incentive policy-making is the responsibility of the National Treasury and SARS would not get involved until a policy decision was actually taken.[1828]

Returning to Nigeria, in this Researcher's opinion, the federal government through the Federal Ministry of Finance should be solely responsible for coordination of economic policy in general, and more specifically, fiscal policy. This is vital to ensure that the state and local governments do not implement suboptimal strategies that may increase local revenues, but ultimately impair broader strategies to increase social welfare, economic growth and development. The state ministries of finance and revenue bodies do not generally possess the administrative capacity and macroeconomic data to design and implement independent national economic policies in all economic spheres. Even if they were seized of such endowments, their motives could tend to enhance state or sectarian interests over national policies or objectives.

The 36 states have legitimate interests in promoting investment and economic growth within their constituencies. However, in respect to fiscal policy, it may be best in most circumstances to have federal ministries or bodies coordinate initiatives across the various tiers of government. For instance, such inter-tier coordination would be useful to control the proliferation of tax-free zones in various regions of the federation.[1829] In this regard, the Draft NTP makes an important contribution towards the promotion of consistent fiscal policy. However, as argued in **§7.2.3** above, the Draft NTP is not sufficiently comprehensive or rigorous in formulating tax incentive policy. There are also concerns over the constitutionality of the Federal Ministry of Finance's purported role in making tax legislation. Care must be exercised that the

[1828] However, SARS had a limited role in interpreting tax legislation in line with fiscal policy: Statement by Sunet Myburg, Official: SARS, Pretoria, South Africa (personal communication 9 May 2007).

[1829] Ondo and Ogun States recently established another free trade zone: Niyi Bello, 'Govt to relocate Naval base to free trade zone in Ondo,' *Nigerian Guardian* (Lagos 19.09.07) <http://www.guardiannewsngr.com/news/article06> accessed 19.09.07.

legislative powers of the National Assembly are not usurped. Finally, the relevant finance and fiscal committees of the National Assembly should be properly constituted, staffed and empowered in such manner as to assist, not impede, constructive and progressive economic policies.

7.4.3. Tax Policy is (limited by) Tax Administration

7.4.3.0. Introduction

Ultimately, tax administration is tax policy.[1830] No matter how well designed tax incentives or other fiscal polices are, the manner in which they are administered will significantly impact their effectiveness. As Newbery observes, administrative capacity is a particularly important constraint on the ability of developing countries to: collect and process information for the design of taxes; audit, assess and enforce taxes; increase tax compliance, reduce tax evasion and otherwise improve the efficiency and effectiveness of their tax systems. *An evaluation of the efficiency of the effective tax system is much more relevant than that of the nominal or legally defined system.* Developing countries may encounter difficulty in predicting precisely all the consequences of tax reforms and may be constrained in choice regarding the range of available taxes. Consequently, in such developing countries, there is a case for fewer tax reforms, greater policy stability and simplicity in tax design and implementation. [1831] The importance of improving the qualitative and administrative capacity of the effective tax system to implement tax incentive policy is well illustrated by considering the following criticisms of Nigerian pioneer industry tax holidays.

7.4.3.1. The Gap between Law and Fact

There is a clear gap between the nominal or legally-defined pioneer incentive system and the practical realities of the effective system. While the

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[1830] Milka Casanegra de Jantscher, 'Problems of Administering a Value-Added Tax in Developing Countries: An Overview', Paper prepared for the Conference on Value-Added Taxation in Developing Countries, (IMF, Washington D.C.: 1986).

[1831] David Newbery 'Taxation and Development,' in David Newbery and Nicholas Stern (eds) *The Theory of Taxation for Developing Countries* (Oxford University Press, Washington D.C.: 1987) pp.200-202.

administrative power to approve pioneer industry applications was previously vested in the Federal Minister for Industries and the National Council of Ministers, the law has been amended to vest this power in the President. It presently appears that the Nigerian Investment Promotion Commission (NIPC), as a Presidential agency, has been delegated the duty of acting for the President. However, the legality of this position is not entirely clear.[1832]

Honourable Bala Bello (Official, NIPC) explained that NIPC handles the normal administration of the pioneer incentives under the ID/ITR Act 1971.[1833] Accordingly, an investor may apply to NIPC for a tax holiday if it falls within specified sectors. The preferred investment vehicle is a company with a minimum paid-up capital of N10million. The investor's application is supported by a presentation made to NIPC's management which must indicate relevant plans, potential and promised performance levels. An NIPC inspection team subsequently visits the investor's factories, plants and other facilities to verify the assertions made in the application and presentation. The investor must apply well before the tax due date because once it has been assessed for tax and pays, is no longer eligible for tax holidays. NIPC inspection team reports to NIPC's management which then determines the application. If satisfied, NIPC approves the application, grants the pioneer status to the company and notifies FIRS, the Ministry of Commerce & Industry's Industrial Development Department and the state Ministry of Industry in the state in which the investment is to be located. However, notwithstanding the tax holiday, the company must still file annual company and tax returns in compliance with all other laws.

Discussions with **Olajide Yesufu** (Tax Unit, MTN Nigeria Communications Ltd) confirm that NIPC and FIRS cooperate in ensuring that pioneer companies maintain separate accounts for pioneer and non-pioneer profits. Olajide Yesufu also confirmed that FIRS usually certified these pioneer profits

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1832 §§1 & 2, ID/ITR Act 1971.

1833 Interview with Honourable Bala Bello, Official, NIPC, NIPC Headquarters (Abuja FCT, Fri 02 February 2007).

as such to ensure that (withholding) tax-free dividends were only paid out of these profits in accordance with §17, ID/ITR Act 1971.[1834]

However, other discussions with **Ambassador Fidelis Tapgun** (former Minister of State for Commerce & Industry Trade) indicate that NIPC did not always exclusively administer pioneer incentives.[1835] Ambassador Fidelis Tapgun stated that pioneer incentives could be made in three ways. Minor applications could be dealt with by the Ministry of Commerce & Industry based on applications by local, indigenous investors. Other applications by mostly foreign investors were handled by NIPC. Finally, applications relating to major investments were sent to a Presidential Committee which considered such applications and recommended deserving applications to the President for approval.

Honourable Bala Bello attributes this dispersion of administrative authority to the realities of NIPC's evolution into an independent agency.[1836] However, there was considerable scope for the exercise of presidential discretion under Obasanjo's regime. In 2001, there were no clear provisions for the grant of tax holidays to mobile telecommunications operators. MTN Nigeria Communications Ltd blazed the incentive trail by applying to NIPC which was under the Vice-President's office at the time. The grant tax holidays for the telecommunications sector was evidently by way of ministerial discretion as

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[1834] Statement by Olajide Yesufu, Tax Unit Officer, Financial Planning Department, MTN Nigeria Communications Ltd, Lagos, Nigeria (personal communication 9 March 2007).

[1835] Interview with Ambassador Fidelis Tapgun, the Honourable Minister of State, Federal Ministry of Commerce & Industry, Ministry of Industry, Old Secretariat, (Abuja FCT, Tues 30 January 2007).

[1836] Honourable Bala Bello volunteered the following explanation for the confusion: previously, an Industrial Development Coordination Committee under the Ministry of Finance carried out functions later assumed by NIPC. NIPC grew out of the Ministry of Industry and was empowered, staffed, resourced and ultimately placed under the Presidency. It later moved into its own offices in the Ministry of Finance before getting the new NIPC Headquarters Building in line with its independent status: Interview with Honourable Bala Bello, *op cit*.

opposed to government gazette as prescribed by §1, ID/ITR Act 1971.[1837] This Researcher has not discerned the legal basis for this apparent allocation of responsibilities among NIPC, the Commerce & Industry Minister, the President and the Vice-President. It is also not clear what oversight role, if any, the Minister of Finance had during the Obasanjo regime in granting pioneer incentives.

Beyond unnecessarily complicating the administration of pioneer incentives, this dispersion of authority undermines transparency and increases the potential for the undue exercise of discretion. It would be interesting to see if the ongoing inquiry into the award of presidential waivers, exemptions and incentives examines the implication of this dispersion of administrative authority for pioneer incentives. Successful reform commences with a sound understanding of the merits and demerits of the existing status quo. However, the greater the gap between the formal, legal tax incentive system and the practical realities of the effective incentive system, the less likely it would be that Nigeria can collect and process information to understand and improve the design and delivery of pioneer and other tax incentives.

7.4.3.2. **Infant industry or infant economy?**

Some economists have argued that the temporary protection of infant industries may serve the useful purpose of protecting a branch of local production from superior foreign competition while that local industry closes the temporal gap by acquiring the necessary skill and experience. In time, such protection may be withdrawn once that industry matures sufficiently to compete with foreign enterprises. [1838] While there may be some merit in temporary protection for select infant industries, critics have faulted the extension of infant industry arguments to support measures protecting entire developing economies from foreign competition. Such infant economy policies

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[1837] Interview with Mrs. Kofo Dosekun, *op cit*; Interview with Ms. Oyeronke Oyetunde, Regulatory Affairs Manager, MTN Nigeria Communications Ltd (Lagos, Fri 09 February 2007).

[1838] John Stuart Mill, *On the Principles of Political Economy*, (London, Green, Longman, Roberts and Green: 1867).

may result in inefficient, highly diversified and unspecialised manufacturing sectors that cannot survive in the absence of protective tariffs and incentives.[1839]

The current list of approved pioneer industries shows a distinct leaning towards promoting an infant economy as opposed to pioneer industries. Currently, there are 69 items on NIPC's List of Pioneer Industries/Products.[1840] As indicated in **§3.2.5.2** above, the scope of preferred manufacturing industries has been significantly expanded since 1971. Besides a few exceptions,[1841] it is hard to conceive of any significant manufacturing activity in Nigeria which cannot be brought within the scope of NIPC's extended list. No clear policy progression may be discerned from a comparison of the original list of 37 items and NIPC's extended list of 69 items beyond the inclusion of certain sectors that were virtually non-existent in 1971.[1842] Indeed, most of the original 37 items have been retained in some form in NIPC's new list.[1843] The original import-substitution strategy is evident in the new list, yet it cannot be said that Nigeria has since acquired any significant competitive advantage in any of the sectors indicated in either lists.

In response to these shortcomings, **Honourable Bala Bello** admitted that the concept of 'pioneer industry' tended to be a rather flexible one extending beyond the Schedule to ID/ITR Act.[1844] Essentially sectors in which the government wished to promote clusters of industries to augment insufficient industrial activity were designated as pioneer industries from time to time. He however conceded that more clarity was needed in discerning the scope of this concept, perhaps by way of a ministerial directive. He also agreed with this

1839 AfDB, *African Development Report 2004*, *op cit*, pp.133-134.
1840 List of Pioneer Industries/Products, Investment Incentives in Nigeria Brochure, Chapter 1: General Incentives, *op cit*, pp.2-6.
1841 E.g. indigenous GSM operations: *ibid*, p.6.
1842 E.g. the manufacture of computers and computer chips: item 37, *ibid*, p.4.
1843 With the exception of cocoa production, bone crushing, and the manufacture of surgical dressings, starch, animal foodstuffs, leather, medical and dental equipment, stationery and furniture.
1844 Interview with Honourable Bala Bello, *op cit*.

Researcher that there should be some empirical analysis to assess when a sector is sufficiently mature enough to allow for a withdrawal of the incentives.

This last point is of particular concern to this Researcher. The pioneer incentive has been operational in some form or the other since 1957.[1845] Yet it is unclear if there has been any comprehensive study reviewing the merits or otherwise of the policy since its inception and redesigning the regime in light of past performance. Sunset provisions are conspicuously lacking. The tax holidays granted to individual concerns may expire, but any particular sector could conceivably enjoy indefinite tax exemptions. There is no explicit expectation that designated infant industries are expected to 'grow up' and mature out of the pioneer incentives within an agreed timeframe. Clearly, it would be beneficial if certain indices were built into the regime to ensure that once an industry reaches a certain level of saturation, performance, output or some other index, incentives should be phased out. Such an exercise may well determine that many items on the current list are redundant. This would help target incentives to only those industries that rank high in the government's priorities conserving scarce fiscal revenues.

7.4.3.3. **Perceived Successes and Lapses**

There are many aspects of the administration of the pioneer incentive regime that are clearly beneficial and should be enhanced. The initial grant of tax holidays was influenced by NIPC's preliminary assessment of the proportion of local content in inputs, export potential, the prospects of employment generation capacity for Nigerians and the degree of value addition, transfer of skills and expertise involved.[1846] When renewing tax holidays, NIPC considers the extent to which the company ploughs back profits into current operations and business expansion. Consequently, approvals are the result of a composite grading system improving the targeting of incentives.[1847]

1845 See the *Industrial Development (Income Tax Relief) Act of 1957.*
1846 However, it was not evident that the impact of any restrictions imposed by WTO regulations had been explicitly considered.
1847 Interview with Honourable Bala Bello, *op cit.*

There is a commendable degree of cooperation between NIPC (which grants the pioneer incentives), the Industrial Development Department (which certifies the company's production date) and FIRS (responsible for tax assessment and administration). The Industrial Development Department made up for the lack of technical capacity of NIPC's Inspection Teams which did not have engineers and other experts to examine the operational integrity of plant and machinery at prospective pioneer industry sites). NIPC implements several anti-avoidance measures to detect and prevent incentives abuse. These measures include requiring FIRS tax clearance certificate reviews, examining the CAC business registration of companies, and auditing immigration and work permit documentation. Recalcitrant companies are denied incentives, blacklisted for renewals and referred to the Economic and Financial Crimes Commission and FIRS.

However, there have been clear instances of costly lapses in incentive administration. For instance, at some point in the past, **NIPC evidently misapplied provisions regarding the length tax holidays**, granting initial exemptions of 5 years renewable for 2 more years, resulting in cumulative tax holidays of 7 years. This practice is clearly contrary to the ID/ITR Act 1971 which only authorises a maximum of 5 years (3 years at first instance, renewable for another 2 years) for tax holidays.[1848] It appears that FIRS eventually brought this lapse to NIPC's attention. The Presidency apparently resolved this lapse by directing that if any company had received initial holidays of 5 years at once, this could stand but no further extensions would be granted.[1849]

However, no statistics were available in respect of how long this lapse persisted for, how many companies benefited from it or what was the aggregate

[1848] Investment Incentives in Nigeria Brochure (Nigerian Investment Promotion Commission), pp.1,8,10,15,16 cf. §10 ID/ITR Act 1971.

[1849] It appears this may have been the case with MTN Communications Nigeria Ltd's incentives: Interview with Honourable Bala Bello, *op cit.*

cost to the fiscus. While one does not expect government agencies to be infallible, it is worrisome that despite the inherent generosity of the tax holiday programme such lapses persist, causing greater revenue leakage than necessary. It is also a cause of concern that in the absence of tax expenditure budgeting, no single government ministry, agency or department appears to maintain comprehensive statistics on precisely what the pioneer tax holiday scheme costs the fiscus per annum since inception.[1850] If such statistics do not exist or are unreliable, it is hard to conceive how the benefits of the incentive regime may be compared with its costs to arrive at any reasonable assessment of its efficiency as an investment measure.

7.4.4. **Concluding Remarks**

Newbery rightly observes that a key challenge of tax administration for developing countries is attracting and retaining suitably skilled personnel and equipping them with adequate facilities and resources.[1851] In the past, FIRS had suffered from this shortcoming due to poor conditions of service for staff. This position has improved with the passage into law of the *Federal Inland Revenue Service (Establishment, etc) Bill 2007* in April 2007. Under the new Act, a percentage of tax revenue is to be retained by FIRS to fund its operations and a new, competitive salary structure for its staff and officials.[1852]

It is hoped that some of these resources would be invested in reviewing the pioneer tax holiday regime and other aspects of Nigeria's tax incentive system to improve the efficiency and effectiveness of these investment measures. Adequate resources should spent on closing the gap between the nominal or legally defined tax incentive system and the practical effective system, rigorously analysing and reviewing statistics on the existing system with a view to targeting incentives at specific pioneer industries and not an entire infant

1850 Teleconference/Interview with Mike Hugman, *op cit.*

1851 David Newbery 'Taxation and Development,' in David Newbery and Nicholas Stern (eds) *The Theory of Taxation for Developing Countries*, *op cit*, p.200.

1852 Mathias Okwe, 'Jumbo pay for tax officials, chairman to get N10.5m yearly,' *Nigerian Guardian* (Lagos 29.08.07) <http://www.guardiannewsngr.com/news/article03> accessed 24.08.07.

economy, building on actual successes and redressing perceived failures. In this Researcher's opinion, only if such resources are prudently applied to the resolution of these issues and the reform of the wider tax incentive system will Nigerian tax incentives stand any chance in promoting sustainable economic development.

7.5. CONCLUSION

This Chapter has traced the recent evolution of Nigeria's tax incentive policy from its origins in NEEDS and the work of both the 2002 Study Group and the 2004 Working Group. It has set out and comprehensively criticised specific aspects of Nigerian tax incentive policy as indicated in the Draft NTP. In particular, concerns have been expressed in relation to the practical expertise and constitutional competence of the Federal Ministry of Finance in designing, implementing and legislating on tax incentive policy.

Overall, the Draft NTP is a welcome development which provides a focal point for the conception, communication and coordination of national fiscal and tax incentive policies. However, there are certain aspects of the Draft NTP that could be better conceived to ensure greater consistency with overarching policy initiatives under the NEEDS, Vision 2020 and the 7-Point Agenda strategies. In this connection, important lessons could be learned in general from international experiences with tax incentives and more specifically from regional exemplars in the South African and Kenyan experiences.

From South Africa, Nigeria could learn to: **target tax incentives** by restricting them to only those sectors where the benefits justify the attendant revenue losses; ensure that tax incentives are **fit for purpose** and apply other, less costly investment measures where the use of tax incentives is inappropriate; review the design and delivery of tax incentives to ensure that they remain grounded in **sound economics** and are not subverted by undue political considerations; **count the cost** of tax incentives in terms of revenues forgone to appreciate the quantum of tax expenditure support provided and to guide their withdrawal where costs exceed benefits; and continuously **consult with the private sector** to enhance tax incentive design, implementation and review.

From Kenya, Nigeria could learn that: **simplicity is golden** in implementing fiscal policies in developing countries with relatively unsophisticated tax systems; in certain circumstances, **bespoke non-tax incentives** might be more effective in encouraging investment and development in special sectors such as agriculture and mining; and **dynamic, sustainable tax incentive policy** was critical for governments to seize global trade opportunities.

In this Researcher's opinion, the most important lesson from these countries' experiences is the common theme that **tax policy is tax administration**: *tax incentive policy is only as good as the practical means by which it is implemented.* If there are real and significant shortcomings in tax administration, these lapses will undermine any efforts at enhancing sustainable development through the use of tax incentives.

Finally, although profound lessons may be gleaned from the South African and Kenyan experiences, prudent Nigerian policymakers would do well to bear in mind the **peculiarities of the local tax culture** – the low level of tax morality, the scramble for slices of the 'national cake', the tendency towards policy inconsistency, the challenges of fiscal federalism, the vital role of the rule of law and the real constraints on tax administration. If the lessons derived from international and regional exemplars are integrated into bespoke policies designed with the realities of the Nigerian environment in mind, there will be a greater likelihood that tax incentive programmes, if prudently and selectively applied in conjunction with other economic policies, may yet contribute to sustainable economic development.

8. CONCLUDING THOUGHTS

"A dream can be the highest point of a life."[1853]

8.1. THE THESIS IN PRÉCIS

This Thesis has presented this Researcher's findings and views concerning the role of tax incentive law and policy in promoting sustainable economic development, comparing the South African and Kenyan experiences with those of Nigeria, with a view to suggesting ways in which Nigerian tax incentive law and policy may be improved. All three countries in their respective economic master-plans – GEAR, ERS and NEEDS – seek to actualise the dream of improving opportunities and quality of life for their peoples. Tax incentive law and policy seem to be one of many strategies adopted by all these countries to attain this end with varying degrees of success.

In Chapter 2, I have considered the nature of tax incentives and identified some of the various forms that these fiscal measures may take including preferential tax rates, investment tax credits and allowances, accelerated and enhanced depreciation, favourable treatment for tax losses and deductions, incentives targeted at economic activities such as finance and employment, and tax incentives applied through the indirect tax system. I have evaluated economic reasons for and against tax incentives for both foreign and indigenous direct investment, highlighting the sharp differences in opinion among economists, policymakers, academics and other commentators. While there is a general consensus among IFI economists that tax incentives are generally ineffective and inefficient policy tools the use of which should be generally discouraged, this view has not been universally accepted among

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1853 Okri, *The Famished Road*, *op cit*, p.574.

policymakers particularly in developing countries where the use of such measures persist.

In my opinion, tax incentives are generally unwieldy tools: where applied in weak and inefficient tax systems, their propensity to do more harm than good may be significantly enhanced. However, from a Nigerian perspective, it is clear that the use of these policy tools is likely to persist notwithstanding arguments to contrary or indeed, pressures exerted by tax conditionality to discourage the proliferation of tax incentives.

In this regard, I could not agree more with Easson who observes that:

> The reality is that this particular discussion – whether the general tax system is more important to potential investors than are special incentives – is, in one sense, rather pointless. What has attracted many investors ... is the low rate of CIT that they would be required to pay: whether that rate is the 'standard' rate, or is a 'special' rate, is unlikely to be of any importance to the investor that qualifies for the low rate. A more constructive approach is to ask whether a country seeking to attract FDI would be better advised to rely upon special tax incentives or on a CIT[1854] system with no special concessions and a relatively low standard rate... The real issue is whether, given the existence of a reasonable general tax system, special incentives may still have a role to play in attracting FDI: in other words, would the more effective policy be to further reduce the standard CIT rate or to combine a reasonable general system with selective special tax incentives?[1855]

Policymakers tend to persist in the belief that they can use such selective interventions to address market failures, investment gaps and other ills citing as examples those (few) countries that have successfully utilised tax incentives (usually alongside other prudent investment policies) to promote investment, economic development and growth. Merely citing the vastly more numerically significant examples of other countries in which tax incentives have not achieved the desired results may not deter the pursuit of economic objectives through the use of tax incentives.

[1854] Companies income tax.
[1855] Easson, *Tax Incentives for Foreign Direct Investment*, *op cit*, p.81.

Consequently, this Study does not seek to answer conclusively the broad query 'do tax incentives work?', but rather illuminate the more narrow discussion of what may be done to improve the impact, effectiveness and efficiency of Nigerian tax incentive law and policy, given the propensity of Nigerian policymakers to use tax incentives.

8.2. KEY RESEARCH FINDINGS

In Chapter 1, certain key research questions were posed. This Researcher discovered the following findings in response to those questions. Regarding the general role of tax incentive law and policy in promoting sustainable economic development in Nigeria, South Africa and Kenya, Chapter 3, 4 and 5 demonstrate that tax incentives play significant and similar roles in promoting sustainable economic development in all three countries. These chapters review the content and scope of tax incentive practices in these countries and demonstrate the wide variety in measures used across these countries. However, there are notable differences in the results and emphasis placed on tax incentives across the three countries.

In the main, the targeted tax incentive policies of **South Africa** are more successful than those in the two other countries. In terms of trends in tax incentive law and policy, South Africa increasingly espouses and implements policies aimed at replacing fiscal incentives with non-fiscal measures such as grants and subsidies. Where tax incentives are retained, there are greater efforts to target incentives at specific sectors (e.g. R&D investment) and phase out incentives where these fail to achieve key policy objectives (e.g. Strategic Industrial Project incentives). **Kenya's** incentive policies are relatively simple, modestly successful and tend to emphasise export-oriented investment and production. However, legitimate questions could be asked about the sustainability of Kenya's tax incentive practices for EPZs.

In **Nigeria**, there is a distinct trend towards the proliferation of tax incentives with the introduction of new, export-oriented incentives without any noticeable reduction in existing tax incentives based on import-substitution strategies. This trend is well illustrated by Nigerian mining tax incentives. Despite declared policy intentions to phase-out tax incentives, the NMMA 2007 provides for these and other fiscal measures to encourage investment in this sector.[1856]

This is not to say that I disapprove of tax holidays for mining activities: I am of the opinion that that, given the need to divert investment away from the dominant energy sector, this measure, if prudently implemented alongside other initiatives, may encourage investment in the mining sector and so promote economic growth and development. However, where tax holidays are utilised for special sectors, they should be: targeted at specific kinds of investment proven to be sensitive to such measures; they should be time-bound both for individual firms and the specific sectors providing such 'infant industries' a limited time to grow; the outcomes of these tax incentives should be carefully monitored; and ultimately, the incentives themselves should be phased-out when they have achieved their purpose (or be discontinued and replaced with more effective measures where they fail to achieve their objectives). I also agree with the Draft NTP in that priority should be give to encouraging investment in infrastructural development. Unless key sectors such as power supply and transportation are improved, growth in other sectors (e.g. agriculture, mining, industry) would be either illusory or unsustainable.

In Chapter 6, I highlight some of the influences imposed by international tax law, regional integration arrangements, and international trade and financial architecture on tax incentive law and policy. In particular, I note that while these issues potentially may have a significant impact on the role of tax incentives in all three study countries it would appear little consideration has been given to these matters in the case of Nigeria. Nigerian tax incentive policy exhibits little responsiveness to the changing realities of international

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1856 §28 NMMA 2007 cf. Federal Ministry of Solid Minerals Development's Mining Journal special publication, 'Nigeria: An Exciting New Mining Destination', *op cit*, p. 6 [Box 'Summary of the Fiscal Regime for Mining'].

tax obligations, regional integration arrangements and the strictures of global trade. This position is quite unsatisfactory. Further, greater attention should be directed at the issue of tax conditionality to ensure that whatever fiscal policies are agreed between the Nigerian authorities and IFIs ultimately have the wellbeing of the Nigerian taxpayer in view. Failure to consider this crucial interest may render any fiscal policies agreed either unworkable or unsustainable.

For this and other reasons, I find in Chapter 7 that Nigerian tax incentive law and policy while clear is not entirely consistent, prudent or appropriate in view of contemporary development needs, available resources and national priorities. Having traced the evolution of contemporary Nigerian tax incentive policy, I set out my key criticisms of the current position as indicated in the Draft NTP document. Drawing from findings from the Nigerian and South African field trips as well as discussions with Kenyan tax experts, I set out some aspects of Nigerian tax incentive policy that I find deficient, but which may be significantly improved if lessons from the South African and Kenyan experiences are carefully considered and applied.

In particular, Nigeria should: target tax incentives to only those sectors where the benefits justify the attendant revenue loss to increase their effectiveness; ensure that tax incentives are not only fit for purpose but also cost-effective; dispassionately review the true economic rationales for tax incentives; count the cost of tax incentives to assess their cost-effectiveness; and adequately consult with the private sector. Further, Nigeria should: keep tax incentive policies and practices simple given her relatively unsophisticated tax system; use non-tax measures where possible to encourage growth in key sectors; and strive for a dynamic, sustainable tax incentive policy that is responsive enough to seize global trade opportunities. Finally, as tax policy is only as effective as the tax administration allows it to be, sufficient and sustained attention must be placed on improving the capacity, quality and effectiveness of Nigerian tax administration.

8.3. CAVEATS

Given the important differences between the Nigerian tax system and the South African and Kenyan counterparts, there are limits to which such lessons may be applied. I consider in concluding Chapter 7 some of these limits arising from the peculiarities of Nigerian tax culture, tax administration, and political realities.

Beyond these limitations are the practical constraints encountered during the course of this research that impose certain limits on the wider application of these findings. In concluding, two of these constraints deserve specific mention. First, it would have been desirable to have been able to visit Kenya and interview in person more tax experts, academics and officials to gain a deeper understanding and perspective into the operation of the Kenyan tax system. As noted earlier, this was not ultimately possible. However, every effort has been made to obtain most of the information required through other means and in my opinion this Study and its findings were not materially affected by this shortcoming.

The second issue concerns obtaining materials and information from Nigeria. While I secured access to all persons that I had initially planned to see at some point during my research, several questions were left unanswered due to the lack of statistical data and other information. There were several situations where policymakers and officials were quite frank in indicating that the information I sought simply did not exists either because there was no data to extract it from or no efforts had been made to process any available data. Moreover, in some circumstances, there was a perceptible reluctance on the part of some civil servants and officials to go on record regarding certain policies and practices. Nevertheless, I do not consider that these constraints have significantly impaired the validity of my findings. In many instances, they only serve to underscore my criticism of certain aspects of Nigerian tax incentive law, policy and practice.

8.4. FINAL THOUGHTS

The South African and Kenyan *Abiku* have, respectively, made significant and notable progress on the road toward the river of sustainable economic development. The Nigerian *Abiku* would be wise to learn from the rich and varied experiences of these two countries. The success of all three nations is vital for economic development on the continent given their important roles in Southern, East and West Africa.

The attainment of sustainable economic development, measured by the achievement of the UN's Millennium Development Goals by 2015, remains a dream for Sub-Saharan Africa. It is exceedingly unlikely that this modest Thesis will make that dream a reality. However, if this Thesis can in some way provide original ideas that may ease the passage of the Nigerian *Abiku* on her onward journey towards achieving sustainable economic development – and encourage her to stay in the Land of the Living long enough this time around to improve the lot of her peoples – this Researcher will be deeply gratified.

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INTERVIEWS, FOCUS GROUPS & PERSONAL STATEMENTS

Focus Group Discussion with Richard Ough and other members of the FIRS Tax Policy Research & Development Department, FIRS Headquarters (Abuja FCT, Weds 31 January 2007) [from 10.00hrs-13.00hrs]

Interview with Ambassador Fidelis Tapgun, the Honourable Minister of State, Federal Ministry of Commerce & Industry, Ministry of Industry, Old Secretariat, (Abuja FCT, Tues 30 January 2007) [from 12.30hrs-13.00hrs]

Interview with Derrick Wogu: Tax Manager, British American Tobacco (Nigeria) Limited, BAT Headquarters (Lagos, Tues 13 February 2007) [from 09.00hrs-09.30hrs]

Interview with Ferdi Vorster: Director, Corporate Tax and Robyn Nathan: Partner, International Tax; KPMG Services (Proprietary) Ltd, KPMG RSA National Office (Johannesburg, Thurs 17 May 2007) [from 10.00hrs-10.30hrs]

Interview with Gavin McEwen: former Head of Tax/Senior Tax Partner, PricewaterhouseCoopers, Kenya; at the Caledonian Club (London, Weds 21 November 2007) [from 09.30hrs-11.00hrs]

Interview with Honourable Bala Bello, Official, NIPC, NIPC Headquarters (Abuja FCT, Fri 02 February 2007) [from 13.00hrs-13.30hrs]

Interview with Ian MacKenzie, Head of Corporate Tax, Webber Wentzel Bowens (Johannesburg, Fri 18 May 2007) [11.45hrs-12.35hrs]

Interview with Michael Honiball: Tax Partner and Director (International Tax), KPMG Services (Proprietary) Ltd, KPMG RSA National Office (Johannesburg, Thurs 24 May 2007) [from 9.30hrs-10.25hrs]

Interview with Mr. Fidel Oday, Chief Administrative Officer, Multilateral Relationships Department, Federal Ministry of Finance (Abuja FCT, Fri 2 February 2007) [from 16.00hrs-16.20hrs]

Interview with Mrs. M.O. Olowu: Director (Fiscal) and Mr. Tor Tsavsar: Assistant Director (Fiscal), Fiscal Department, Budget Office of the Federation, Federal Ministry of Finance (Abuja FCT, Tue 6 February 2007) [from 11.40hrs-12.00hrs]

Interview with Ms. Oyeronke Oyetunde, Regulatory Affairs Manager, MTN Nigeria Communications Ltd (Lagos, Fri 09 February 2007) [from 06.30hrs-07.00hrs]

Interview with Ms. Rita Maselia, Official, Federal Ministry of Finance (Abuja FCT, Sat 3 February 2007) [from 12.30hrs-13.30hrs]

Interview with Rendani Neluvhalani: Director, International Tax; Ernst & Young Advisory Services Ltd, Ernst & Young RSA National Office (Johannesburg, Thurs 24 May 2007) [from 13.30hrs-14.25hrs]

Interviews with Mrs. Kofo Dosekun: Partner, Aluko & Oyebode (Lagos, Fri 26 and January and Thurs 08 February 2007) [from 10.20hrs-10.40hrs; 13.15hrs-13.40hrs]

Obayiuwana, Interview with Omoigui Ifueko, Chairperson, FIRS: O Obayiuwana, 'Are Nigerians ready to pay tax?' *BBC News/Africa* news article (London 6 June 2005) <http://news.bbc.co.uk/2/hi/africa/4614121.stm> accessed 26 September 2007

Statement by Christine Muga: Tax Associate, PricewaterhouseCoopers Channel Islands; formerly of Ernst & Young Eastern & Central African Advisory

Services' Tax Department, Nairobi, Kenya: (personal communication 7 December 2007)

Statement by Gavin McEwen, former Head of Tax/Senior Tax Partner, PricewaterhouseCoopers, Kenya: (personal communication 12 September, 2007)

Statements by Johnson Salako, CEO: Goland Petroleum Development Company, Lagos, Nigeria (personal communication 26-28 April, 2006)

Statement by Olajide Yesufu, Tax Unit Officer, Financial Planning Department, MTN Nigeria Communications Ltd, Lagos, Nigeria (personal communication 9 March 2007)

Statement by Sunet Myburg, Official: SARS, Pretoria, South Africa (personal communication 9 May 2007)

Statements by Eyo Ekpo, (former) Attorney-General, Cross Rivers State, and Orok B. Okon, Personal Assistant to the Attorney-General, Cross Rivers State, Nigeria (personal communication 5 April, 2007)

NOTES

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